S. Hrg. 99-33

THE UNITED STATES IN A GLOBAL ECONOMY

HEARINGS

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

FEBRUARY 27, 28, AND MARCH 6, 1985

Printed for the use of the Committee on Foreign Relations

45-582 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1985

S381-23

COMMITTEE ON FOREIGN RELATIONS

RICHARD G. LUGAR, Indiana, *Chairman*

JESSE HELMS, North Carolina
CHARLES McC. MATHIAS, Jr., Maryland
NANCY L. KASSEBAUM, Kansas
RUDY BOSCHWITZ, Minnesota
LARRY PRESSLER, South Dakota
FRANK H. MURKOWSKI, Alaska
PAUL S. TRIBLE, Jr., Virginia
DANIEL J. EVANS, Washington

CLAIBORNE PELL, Rhode Island
JOSEPH R. BIDEN, Jr., Delaware
PAUL S. SARBANES, Maryland
EDWARD ZORINSKY, Nebraska
ALAN CRANSTON, California
CHRISTOPHER J. DODD, Connecticut
THOMAS F. EAGLETON, Missouri
JOHN F. KERRY, Massachusetts

Jeffrey T. Bergner, *Staff Director*
Geryld B. Christianson, *Minority Staff Director*

CONTENTS

Page

Hearing days:

February 27, 1985 ... 1
February 28, 1985 ... 87
March 6, 1985 ... 217

Statement of:

Andreas, Dwayne O., chairman of the board and chief executive officer, Archer Daniels Midland, Decatur, IL ... 256
Brock, Hon. William E., U.S. Trade Representative ... 219
Cooper, Richard N., Maurits C. Boas professor of international economics, Center for International Affairs, Harvard University, Cambridge, MA ... 88
Debs, Richard A., president, Morgan Stanley International, Inc., New York, NY ... 26
Feldstein, Martin, president, National Bureau of Economic Research, Cambridge, MA ... 108
Fowler, Hon. Henry H., limited partner, Goldman Sachs & Co., New York, NY ... 128
Hormats, Hon. Robert D., vice president, Goldman Sachs & Co., New York, NY ... 185
Roosa, Hon. Robert V., partner, Brown Brothers Harriman & Co., New York, NY ... 313
Tanselle, Donald W., vice chairman, Merchants National Bank & Trust Co. of Indianapolis, Indianapolis, IN ... 68
Trowbridge, Alexander B., president, National Association of Manufacturers, Washington, DC ... 327
Volcker, Hon. Paul A., Chairman, Board of Governors, Federal Reserve System ... 4
Vojta, George J., executive vice president, Bankers Trust Co., New York, NY ... 52

Insertions for the record:

Foreign assets in the United States ... 18
Prepared statement of Richard A. Debs ... 30
Prepared statement of George J. Vojta ... 54
Prepared statement of Donald W. Tanselle ... 70
Prepared statement of Richard N. Cooper ... 93
Prepared statement of Martin Feldstein ... 113
Prepared statement of Hon. Henry H. Fowler ... 134
Prepared statement of Hon. Robert D. Hormats ... 190
Prepared statement of Hon. William E. Brock ... 224
Prepared statement of Dwayne O. Andreas ... 259
Prepared statement of Hon. Robert V. Roosa ... 316
U.S. trade balances with major trading partners ... 329
NAM resolution on the exchange rate for the U.S. dollar ... 332
Prepared statement of Alexander B. Trowbridge ... 336
Senator Mathias' amendments to establish as an executive department of the Government of the United States a Department of Trade ... 359
The need for a private enterprise by Paul Laudicina, director, SRI International, Arlington, VA ... 367

THE UNITED STATES IN A GLOBAL ECONOMY

WEDNESDAY, FEBRUARY 27, 1985

United States Senate,
Committee on Foreign Relations,
Washington, DC.

The committee met, pursuant to notice, at 10:03 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar (chairman of the committee) presiding.

Present: Senators Lugar, Mathias, Evans, Pell, Biden, Zorinsky, Cranston, and Kerry.

The Chairman. This hearing of the Senate Foreign Relations Committee is called to order.

I am pleased to join today with my colleague, the distinguished Senator from Maryland, Senator Mathias, the chairman of the International Economic Policy Subcommittee, in opening this series of three hearings on the international economic component of the Committee on Foreign Relations' comprehensive examination of the future of American foreign policy.

Senator Mathias and his subcommittee held a number of very high quality hearings in the last Congress exploring the general theme of stresses and strains in the international financial system. I look forward to joining with him today in the committee's continuing exploration of these global economic issues.

This committee's hearings, which began with Secretaries Shultz and Weinberger on January 31, have involved a thorough and intensive examination of our Nation's foreign policy. We have thus far given particular attention to the issues of arms control and relations with our major adversary and competitor, the Soviet Union.

We now turn to the international economic aspects of our global challenges and responsibilities. The foundation of our national security and that of our friends and allies ultimately rests on the strength of our domestic economies. Our attempts to ensure not only our defense, but also to enlist the participation of our allies in the defense of the West, could be undermined by a failure of Western leaders not only to manage their own economies, but also to manage the connections between their economies and those of the rest of the world.

In these matters, as in others this committee has explored in recent weeks, the consensus that we seek is important: Consensus at home and abroad, consensus not only with respect to the nature of the economic challenges we face, but of equal importance, consensus about the means to meet these challenges.

We all recognize, for example, that the management and—it is too early to speak about the solution—of the debt crisis which surfaced in 1982 depended on the cooperative efforts of governments, central banks, multilateral institutions, and literally hundreds of commercial banks. There is an important lesson in this cooperative response to crisis. No one country, however powerful, could have dealt with the debt problems of Mexico, Brazil, and Argentina.

Americans can take pride in the role played by this country, not only in dealing with the debt problem, but more generally in contributing to the restoration of global economic growth. Our economy has been the engine of recovery, pulling others along behind it.

But there have been costs associated with our efforts. The high value of the U.S. dollar and our unprecedented trade deficits are evidence of problems which, if not resolved, could seriously undercut continued global economic recovery.

The relatively unfavorable terms of trade, coupled with the conviction of many segments of American society that other nations trade unfairly, could lead us and ultimately the remainder of the world toward highly protectionist measures.

Americans recognize that they live in an economically interdependent world. They need to be assured, however, that the global competition is not unfairly stacked against them.

During the 3 days of hearings we have scheduled, the committee will consider the economic challenges which confront our Nation and the range of choices we have to meet those challenges. We will be especially interested in the witnesses' views on how the United States can contribute to stimulating and sustaining economic growth.

It is my own conviction that sustained economic growth is vital to our future. It is vital to the capability of the United States and our allies to pay for important social programs and a strong defense. It is also vital for developing nations in order to create strong, prosperous, and just societies.

We are particularly fortunate in having the Chairman of the Federal Reserve Board, Mr. Paul Volcker, here this morning to lead off these hearings. He will be followed by a panel of financial experts.

At this point I would like to turn first of all to my colleague, the distinguished ranking member of the committee, Senator Pell, for his opening remarks.

Senator PELL. Thank you very much, Mr. Chairman.

Today we begin the first of a series of hearings on "The United States in the Global Economy" as part of the Committee on Foreign Relations overall efforts to assess U.S. foreign policy interests and goals. Let me commend you Mr. Chairman and Senator Mathias as chairman of the International Economic Policy Subcommittee for holding these hearings since any attempt to paint a comprehensive picture of U.S. foreign policy interests would be incomplete without a serious review of U.S. international economic policy. More than ever before, U.S. trade, monetary and investment relations with our allies and adversaries have grown in importance as a determinant of our overall relations.

Frictions, particularly with our allies, have more often than not been generated not by divergence in our shared political goals but rather in specific transactions in the economic sphere. These frictions, however, have often spilled over into political relations to the detriment of our broader foreign policy initiatives. On the flip side, how often have politial decisions concerning relations with our adversaries had unintended and often undesirable effects on domestic economic repercussions?

It is my hope that the 3 days of hearings which begin today on the international economy will not only illuminate the important linkages between the state of U.S. economy and that of the larger global economy, but will also go on to explore the vital but more complex linkages between U.S. trade, monetary and investment policies, and our broader foreign policy goals.

The CHAIRMAN. Thank you very much, Senator Pell.

Now I would like to turn to Senator Mathias for his opening comments.

Senator MATHIAS. Thank you, Mr. Chairman.

Very briefly, I am pleased to be joining you in what I think will be an extremely useful effort to get a better appreciation of the economic challenges that not only face the Nation, but which will have an intimate and direct bearing on foreign policy issues.

I think you are to be congratulated not only for the excellent hearings that the committee has held on the question of the future of American policy, but particularly for recognizing that one of the fundamental pressures on foreign policy will be the economic factor, which could play an enormous role in the success or the failure of our security policies in the future.

I remember from my Navy days that there was a phrase that we used, when a ship was "under way with no way upon her." Being under way with no way upon her, as Senator Pell will recall, is another way of saying you are dead in the water.

We may be in a critical stage of the economic recovery cycle. There are forces building that could put us in that position, of being under way with no way upon her. There are forecasts of lower economic growth for the rest of this year and next year, and that lower economic growth could have very negative consequences for Europe

I am talking about lower economic growth in the United States, which could have very negative economic consequences for Europe and disastrous economic consequences in Latin America, because both Europe and Latin America have looked to the United States to provide the locomotive force for their own economies.

Now, of course, lower economic growth here could have serious consequences in our domestic economy. We are already laboring under the burdens of budget and trade deficits that are putting the economic recovery at risk. The longer we delay in taking effective action, the greater will be the risks and in turn inevitably the greater the burden that we leave to our children and our grandchildren.

So I hope that these hearings will help us to define the issues that we face and to shed some light on the path that we ought to choose.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mathias.

Senator Zorinsky, do you have an opening comment?

Senator ZORINSKY. Thank you. I do not.

The CHAIRMAN. Mr. Volcker, would you proceed with your testimony.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman and gentlemen. I am pleased to be with you this morning to discuss the role of the United States in the global economy. That role, of course, has many dimensions and I can only touch upon a few of them this morning—specifically on the relationships between our expansion and growth in the world generally, certain aspects of trade and exchange rate policy, and the problem of developing country debt.

As you know, we have enjoyed a strong recovery for more than 2 years, with the real gross national product [GNP] rising by some 12½ percent from the fourth quarter of 1982 to the fourth quarter of 1984.

GNP is a measure of production. Throughout this period, domestic demand has increased faster than the GNP. In essence, a significant fraction of demand currently generated here—more than 2½ percent—is now flowing abroad, providing stimulus to production overseas. Put another way, U.S. purchases of goods and services have increased by about 15 percent over the past 2 years, as compared to the roughly 12½ percent increase in production.

With strong stimulus absent in the rest of the world, the growth of demand in the United States represented 70 percent of the total growth of demand in the OECD [Organization for Economic Cooperation and Development] area from 1982 to 1984, even though we accounted for only 40 percent of OECD GNP in 1982. Moreover, countries outside the OECD area, including importantly many countries in Latin America, have similarly benefited from the vigor of U.S. recovery.

The difference in economic performance over this period has been starkly evident in employment figures. In the United States, jobs increased by 7 million since the end of 1982. In contrast, there has been virtually no increase in employment in the rest of the OECD area as a whole, and in many of those countries unemployment rates have continued to fluctuate around their post-World War II highs.

At the same time, the growth and relative dynamism of the American economy have helped attract a flow of funds from abroad, strengthening the dollar even as our external trade and current accounts have moved into deep deficit. The growing net capital inflow—now supplementing net domestic savings of individuals, businesses, and State and local governments by nearly a third—has been a critically important factor in enabling us to finance both rising investment and the enormous Federal deficit. The strength of the dollar and the ready availability of goods from abroad have also been potent factors restraining price increases for manufactured goods in the United States.

From one perspective, those results are gratifying for us, and our trading partners have benefited as well. But there are, of course, flaws—flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment. There have been exceptionally high levels of unemployment in many other industrialized countries, and, looking ahead, too few signs of significant improvement in that respect. Moreover, the financial position of the heavily indebted developing countries remains vulnerable. Those difficulties feed back on prospects for our exports and our financial system. Interest rates remain high relative both to historical experience and to recent rates of inflation.

Those strains have specific causes and potential remedies. But it is also true that they are aggravated by underlying imbalances in our trade and budgetary accounts. U.S. trade and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy U.S. economic growth.

Economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely in a framework of growth and prosperity. They imply a dependence on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy essential to a strong currency and to prospects for lower interest rates. But the hard fact is that we have come to rely on that foreign borrowing to finance the combination of a budget deficit and the private investment demands generated by a growing economy. The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 percent of net savings—or about 8 percent of gross savings—in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances, and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

It seems to me essential that those pressures be resisted. There are powerful reasons why such an approach is not in our economic interest, whatever the response abroad.

For instance, we have encouraged developing countries to adopt policies that will enable them to service their debts, to enhance over time their productive capacity, and to grow. Success is dependent upon their ability to increase exports—and as their exports grow they will also import, from the United States and from other industrialized countries. But that success will be denied if the United States and other industrial countries protect their own markets from fair competition by developing countries.

Even if we could somehow shield developing countries from broad protectionist measures—and it is not clear that in practice we could do so—there are other high economic costs from widespread protectionism. Quotas, new tariffs, or import surcharges all act directly to raise prices, and the problem would not be temporary if the effect would be to refuel inflationary expectations—just at a time when so much progress has been made in changing that psychology. Other things equal, protectionist measures that actually had the effect of appreciably reducing some imports would presumably be reflected in still further upward pressures on the dollar, hurting exporters and industries not protected.

Beyond those specifics, there are potentially much more damaging risks of a breakdown in a world trading order built up so laboriously after the chaos of the 1930's.

Consider, for example, the proposals now being discussed for a temporary import surcharge. Those proposals are sometimes coupled with other measures to reduce our budget deficit. Such proposals are offered as a relatively painless means of raising Government revenue while simultaneously addressing the trade deficit.

One attraction is that an import surcharge effectively taxes foreign exporters as well as domestic residents. But it is also clear that any benefits, either for trade or for the budget, would be temporary. More lasting favorable consequences of the proposals would be derived not from the temporary surcharge but from the accompanying budget measures.

I would question whether the imposition of a surcharge makes those accompanying measures easier, or more difficult, to enact. In any event, so attractive a tax to the United States would certainly be attractive to others as well. Most countries have budget deficits larger than they would like, and with high unemployment would not be averse to reducing imports. If the surcharge approach is, in effect, legitimized by the United States, wouldn't others find almost irresistible temptations to emulate our example? Would that not eliminate any net benefits and also have destructive implications for world trade—upon which our hard-pressed farmers, among others, are so dependent?

At a more fundamental level, we cannot logically take actions to reduce our trade deficit and at the same time welcome the associated capital inflows from abroad. The trade deficit and our capital inflow are two sides of the same coin. Unless we reduce our budget deficit, success in improving our trade balance, and thus reducing the capital inflow, will only threaten stronger pressures on our domestic financial markets, jeopardizing housing and investment.

In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium. I know of no approach to that problem that promises success other than straightforward measures to reduce our budget deficit over time. Approaches that obscure that basic need will, in the end, be counterproductive.

I do not want in any way to suggest that, important as action with respect to the budget deficit is, that approach will somehow deal with all the problems of the global economy. In particular, other industrial countries have clear responsibility and opportunity to take actions themselves to enhance their economic prospects. The importance of policies to deal with structural rigidities in their economies has often been noted. Moreover, in some important countries where inflationary pressures have been successfully contained, and where credible long-term anti-inflationary monetary policies are firmly in place, there may be scope for action to stimulate their growth by constructive measures to speed tax reductions or otherwise.

Certainly, much remains to be done to restore sustainable growth patterns in much of the developing world. Over the past 2 years or more, a number of the more advanced and largest developing countries, particularly in Latin America, have made serious efforts to implement appropriate adjustment programs in conjunction with IMF and private financing arrangements. Clear progress—in some cases, spectacular progress—has been made in eliminating or narrowing external imbalances. Mexico and Venezuela in Latin America, and Yugoslavia and Hungary in Eastern Europe, have produced current account surpluses. Brazil's current account deficit was essentially eliminated last year. Happily, most of those countries have also managed to restore a measure of domestic growth. All of that progress was facilitated by access to foreign markets, most importantly to the United States.

In some instances, the progress in adjustment has encouraged and justified longer term or multiyear restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico, Venezuela, and Ecuador, and serious negotiations are underway with Brazil and Yugoslavia.

However, these signs of progress do not mean that the "debt problem" is behind us—or that, more broadly, the borrowing countries are now firmly on a path of sustained strong growth in a context of political and economic stability. Indeed, some of the more fundamental adjustments necessary to that end are still absent or only partially in place. Inflation, for instance, remains disturbingly high in many of the countries, and in some is still rising to new peaks. Spontaneous new investment by either domestic firms or from abroad has often been slow to develop, reflecting in considerable part concern in some countries about the role for private investment and the degree of controls and market distortions. Moreover, on the more purely financial side, cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required despite the protracted and tedious nature of the process. Rather than impatience, the need remains for energetic and constructive approaches to the longer term probems faced by individual countries.

I will conclude with a few words about the dollar. Few, if any, anticipated the degree of strength that the dollar has displayed persistently for some time, nor can it fully be explained by such factors as relative interest rates or differences in inflation rates. No doubt, relative confidence in our economic prospects, in our political stability, and in our business climate have played a part, as has a sharp diminution in our bank lending abroad. At the same time, the widening gap in our trade position suggests that our basic competitive position cannot support so high a dollar indefinitely.

The policy question is what measures can be taken to encourage a reasonably competitive equilibrium over time? I suggest that the general approach I have alluded to today would work in that direction.

Credible measures to reduce the U.S. budget deficit would alleviate one source of inflationary concern and encourage lower real interest rates than would otherwise be the case. In that environment, some other important industrial countries might find it easier to undertake more stimulative policies at home. If they managed at the same time to deal more effectively with some structural rigidities, the perceived contrast between the opportunities in the U.S. economy and the relative sluggishness of European economies could constructively be diminished. If developing countries could reduce inflation and restore more confidence in their own business climate, their own citizens would then employ more of their savings in their own countries and funds could again be attracted in greater volume from the United States or elsewhere.

At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact. That is why measures to deal with the fundamental imbalances in our own financial requirements are so important.

Over the near term, prospects for the economic performance of the United States, and to a lesser extent the rest of the world, appear to be favorable. We want to build sensibly on those strengths and to deal in a lasting way with the imbalances. Purely symptomatic treatment is not adequate—and, in the form of protectionism, will be counterproductive. The more basic approaches necessarily take time, and we have let too much time pass already. But fortunately, we can still proceed from a position of strength, and I trust we will make the most of the opportunity before us.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Volcker.

The committee will now question the witness, with a 10-minute time limit on the questions from each Senator.

Mr. Volcker, you mentioned in your testimony that there are now proposals in this country for temporary import surcharges, and you have argued that these might have temporary possibilities, but would be overcome as other players came into this situation and new rigidities were brought into play.

Let me ask you about a very specific aspect of that question. What would your comment be if the Congress were to propose and adopt, or at least adopt a resolution suggesting the administration move to implement an economic surcharge with regard to Japan specifically?

I ask this question because in one forum after another negotiations for specfic entry into Japanese markets, whether it be for electronic goods or wood or farm products or what have you, have really broken down and we are withdrawing our designees for the time being, simply in frustration. The amount of imbalance with Japan grows extraordinarily large and we now have the prospect of some careful observers to the American economic scene arguing that it makes no sense to withdraw pressure on the automobile question when in fact we seem to be making no headway whatsoever on a broad range of issues.

I would further ask the question in the context of your remarks that other nations might wish to follow. Will you respond to the specific area of a surcharge with Japan until we come into openness and liberalization of trade relationships and what is perceived as a much more fair situation in our relationship with that country?

Mr. VOLCKER. Let me say, first of all, that I think that specific question is quite different from the question of a general surcharge.

The CHAIRMAN. Yes; it is.

Mr. VOLCKER. I just want to make the distinction that it does not carry the same budgetary implications and so forth. It also, I think, raises some legal questions about our international obligations, which I do not want to address.

When you look at our deficit and when you look at where the countervailing surpluses are around the world, the one that looms out is Japan. Japan has benefited generally, not just from a surplus with the United States, but also with the rest of the world.

In terms of Japan's own growth in the past couple of years, it is a prime example of a country that has been growing pretty well, but a very large part of this growth has been built upon external demand rather than internal demand.

Put that against the longer term background that you were alluding to, of a rather long history of difficulties in exporting manufactured goods in particular to that country, and the seemingly impenetrable conditions that sometimes exist there—whether for legal reasons or otherwise—and you have a good deal of frustration and a good deal of concern, which gives rise to your question.

I, nonetheless, must say that I have some concern about that kind of unilateral action in terms of precedents for the future, and in light of even the shorter term difficulties that that might create politically as well as economically. So I would be very hesitant, but I understand the frustrations that give rise to the question.

The CHAIRMAN. Well, at least you are not knocking it out of the ballpark with the same vigor as the general idea of import surcharges as I, at least, read between the lines of your answer.

Mr. VOLCKER. I am not really very happy that we would ever have to resort to that kind of thing, and I would hope that these negotiations—which I know have gone on interminably, and not just in this administration, but in past administrations—are making headway. I think there has been progress, in fairness.

Senator BIDEN. Mr. Volcker, are you sure you are not from the State Department? [Laughter.]

Mr. VOLCKER. Oh, I am multipurpose. [Laughter.]

The CHAIRMAN. Well, fair enough.

Let me ask a question that comes back into the Federal Reserve Board situation more particularly. In recent testimony you have pointed out that the Fed would not be making interest rates go higher or lower insofar as that is within your powers to do so but to have a sort of benign neutrality for the time being.

Most observers believe that the strength of the dollar has a depressing effect upon the ability of American businesses to raise prices, perhaps American labor unions to come into different wage arrangements, but only probably in the areas where there is foreign competition. In the services industries, that really has not prevailed.

So we sort of have a two-class America with this type of situation.

Is there not a case to be made that if we were to attempt to lower interest rates, or at least to impose certain circumstances in which they would be more likely to decline, that this would be helpful in terms of the success of American businesses, American agriculture. A good bit of pressure is imposed by high interest rates in terms of their success, they do not have the possibility of raising prices, and given the strength of the dollar, much of the work the Fed might have done at other times is being imposed by external circumstances. Would it not make sense in terms of other nations if our interest rates were lower and theirs might go lower, too, given that the attractions of our economy might be less.

Mr. VOLCKER. It all sounds very nice, and I agree with that vision, but I think it depends upon how you get the lower interest rates in the United States. I think all the benefits that you cite flow rather directly, if the reduction in interest rates comes about in a way that does not promise more difficulties down the road. Obviously what I am alluding to is that if you help encourage that process by correcting this imbalance in our own financial markets by reducing the budget deficit, I think all those favorable consequences flow.

If we try to do it by inflating the money supply and advertently or inadvertently give rise to a rebirth of inflationary forces, I think then that no reduction in interest rates is going to last very long, and we will end up with higher rather than lower rates.

Just to broadly summarize, I do not think we can get out of this problem by printing money excessively, anyway.

The CHAIRMAN. I would agree, but is there not a case to be made for at least a bias toward slightly lower interest rates, both in the international scene as well as the domestic?

Mr. VOLCKER. We are not going to control interest rates that directly, but if you raise the question whether the strength of the dollar and all of those pressures on certain sectors of the economy which eventually have an effect on other sectors as well—even though they are not so directly involved in trade whether that should influence policy, I would have to say to you it has been an influence on policy and that we have in conducting policy, I think, taken that into account.

Now, you can to a degree, debate as to precisely what the appropriate degree should be, and that is a legitimate debate, but I would say that it has been an influence on the attitude we have taken toward growth in the money supply in relation to our various targets and so forth. It by no means means that we can abandon that discipline of appropriate growth in the money supply, but in all the decisions that we make, in implementing policy from week to week or month to month, I think that has become a more important factor.

The CHAIRMAN. Would there not be value in trying to get interest rates down just with regard to the work out policies we already have with Mexico and Brazil and what have you?

Mr. VOLCKER. Yes. There are a lot of advantages in lower interest rates if you get them in the right way, and I would not deny that for a moment. There are advantages to the developing countries; I think it would help the expansionary process in other industrialized countries. It is obviously of benefit in terms of many sectors of the American economy, and would tend to relieve excessive pressures on the exchange rate: all those things follow, but I think they all follow if you have the basic conditions that can be consistent with lower interest rates, and sustained lower interest rates.

The fact is the overall economy has been growing pretty well, even at these high levels of interest rates.

The CHAIRMAN. Thank you very much

Senator Biden?

Senator BIDEN. Thank you, Mr. Chairman.

Mr. Volcker, having served on the Budget Committee since its inception and having had the opportunity to hear you testify on a number of occasions, I always marvel at how your statements are taken with such force around the world. I heard this morning on the radio that your comments caused the dollar to fall. I read today in the Post the dollar falls after Volcker's testimony. Sometimes you must wonder whether or not you should say anything, which explains why you sound like someone from the State Department most of the time. [Laughter.]

Let me ask you a question based on something you said yesterday.

When you were asked, you said you could not predict when foreigners might become less willing to invest in the United States, but you added "It is an increasingly uncomfortable situation. We are putting ourselves at risk."

Could you elaborate on that, what you mean by that? What risk are we putting ourselves at, for the record?

Mr. VOLCKER. We are in a situation where increasingly, over the past couple of years, we have—I will use the words "benefitted from"—a capital inflow which approached $100 billion last year, if we take the figures literally. We have never seen anything like that before. The world has never seen anything like that before in terms of magnitude of capital flows into one country.

We are on a trajectory right now, I think, where our trade deficit will get still larger and our current account deficit will get still larger, and to cover those deficits, we are going to have to borrow still more abroad. But when that money comes freely, as it has certainly come—there have been a lot of incentives, obviously, to keep money in the United States or for foreigners to put money in the United States—it is relatively comfortable overall, primarily because it helps to keep our interest rates down, although the trade consequences are obviously very adverse to some sectors of the economy.

I think you have to ask yourself as to whether it is logical or at all likely to expect those conditions of a rising capital inflow, already large, already amounting to I think 15 percent of the net savings of the other industrialized countries, whether to continue indefinitely.

A year ago I would have had a question in my mind as to whether $100 billion would come in so easily. Obviously it did, and it may come in for a while longer, but it——

Senator BIDEN. I did not think it would, because we talked about that.

Mr. **Volcker**. That is right, and I would not have estimated it either, frankly.

Senator **Biden**. I was dead wrong.

Mr. **Volcker**. And maybe some more can come. The forces are obviously very strong. But among other things, it carries the seeds of its own destruction. The bigger the debts get, the greater the risk that eventually that confidence that underlies part of the capital inflow gets undermined.

Then what is the risk? You have a big trade deficit, you have a big current account deficit, you have to borrow abroad because it has to be financed, and those deficits do not change—they can change over time, all right, but they do not change overnight. If you get a different psychology and a different set of conditions, including lower interest rates, let's say, all other things equal, and you get a tendency for people to want to not put money in—indeed, a tendency to take it out, collectively—conditions can change because so long as the trade deficit is there, we are going to have to borrow.

What it reduces to is the terms and conditions under which we borrow when we have that deficit, and there are two main aspects of that price, the exchange rate and the interest rate, and while I think it is foolish to try to make any very precise projections here, at some point you face the risk of very substantial pressures on interest rates and exchange rates, unless we have meanwhile reduced our dependence internally on that capital inflow. That brings you back to the budgetary problem.

Those consequences need not be frightening if we make room in domestic policies for getting along with less capital inflow. And that is essentially what I am urging.

If you wait until it happens, of course, it is too late.

Senator **Biden**. Let me pursue that a bit because we up here, most of us—I speak for myself, and I do not want to paint my colleagues with the same brush, but I suspect most of the Members of the Senate and most economists who have testified before us, whether they have been characterized as liberal or conservative, have been wrong about the strength of the recovery, the length of the strength, and about capital in flows, but everyone has been basically right about the deficit and the scope of the deficit. We have argued over $10 billion to $30 billion differences, but everyone has acknowledged for the last 2 years, that it was going to be in fiscal year 1985, is it going to be in fiscal year 1986 or fiscal year 1987, a significant number.

Yet, I have yet to—and I do not suggest you have the answer, but I want to lay out my dilemma and maybe you can comment on it—I am very sympathetic to what the Senator from Indiana said both as it relates to the voluntary restraints on Japan and as it relates to his concern about getting interest rates down because of the nature of the effective dual economy we are beginning to run here in some sectors. But I find it is kind of a catch-22 situation because I have yet to get an answer, or I do not think there is any consensus—I may be wrong—on how we explain the continuing strength of the dollar and the rationale for the inflow of capital. I have first bought off on the notion it is because of interest rates.

Well, then you look around the world, and it does not seem to explain to the degree to which it continues the amount and consistency and from whence it comes.

Then I bought on to the notion that it is probably political stability and long term optimism about our prospects, but then as you look at the growing concern about our deficits that any rational person has to be at least concerned about—where they come out on it, I do not know—and this is a long way of getting to my problem, which is the last point you made. Because I do not know why, because I feel I do not have a good handle on why there has been such an inflow of capital, and because I think part of it has to do with interest rates, I find myself in a catch-22 position in terms of my thinking. If in fact the Fed or through fiscal policy on the part of the Federal Government we are able to move interest rates down, if we move rates down more rapidly than is prudent, do we then cut off the inflow, and in fact, precipitate the problem, make it so bad that interest rates end up much, much higher, because as you pointed out, literally in a matter of days, in some cases hours, that capital can flow out, but we sure cannot do much about the deficit through either monetary or fiscal policy, we cannot do much about interest rates or the dollar in the same timeframe.

And so I am wondering, I find myself now in the dubious position of saying, well, maybe we had better have interest rates not move down too much because if they do, and so on.

You understand my problem.

Mr. VOLCKER. I understand your problem.

Senator BIDEN. Would you maybe comment on it a little bit? I am anxious to hear you.

Mr. VOLCKER. Let me comment on the problem precisely as you posed it at the end, your concern that interest rate movements might interrupt the capital inflow, and the net result is you are going to get more inflation and higher interest rates in the end. I would answer to that "precisely," if it is done in the wrong way.

We could undoubtedly conduct a monetary policy that so undermined the confidence that underlies some of this capital inflow, as well as maybe, in the short-run, moved interest rates down, that you would get precisely the result in a very short period of time that you fear. I do not think that course is open to us; we cannot artificially push interest rates down and expect that to be consistent with continuing the capital inflow that we are hooked upon so long as we have this basic imbalance in the domestic market.

The best that would result—and it would be, I am afraid, a little more turbulent than this—is that you would help all those sectors of the economy, in our two-phased economy now, that are dependent upon trade, and the pressures would snap right back on housing and domestic business investment, and I do not think that that would be any help to anybody.

If you give me a different scenario, that basically you work toward getting interest rates down in a way that encourages confidence in the economy, encourages confidence in the sustainability of growth, encourages confidence that interest rates can come down consistent with inflation coming down, then you have an entirely different picture. Of course, I am idealizing these alternatives, but that latter result is through the route of dealing with the budget deficit.

Senator BIDEN. Thank you. I know my time is up. May I follow up with one that relates, a small question?

The CHAIRMAN. Yes.

Senator BIDEN. In your opinion, what would the effect be of a move on the part of the Congress to say we do not have time to go through all the machinations of whether we cut this program, add to that program, we are just going to freeze everything, freeze Government spending, period, no department gets any more this year than they got last year, what in your view is the psychological effect, not whether that is prudent in terms of Government planning, but what effects do you think—and I know you would have to guess, but if you would please do so—what effects do you think that action would have?

Mr. VOLCKER. Well, I think that kind of action in amounts that were significant——

Senator BIDEN. It would be about $35 billion to $40 billion.

Mr. VOLCKER. In the past I have said that you probably would have to do upward of $50 billion for psychological impact and market response. Whatever you do does not take effect for some time, but in terms of expectations, in terms of impacts on markets, that is the kind of magnitude that probably is critical, that is a market judgment, for what it is worth.

But that kind of action would, I think, be credible, carried through not just for year one but consistent with reductions in deficits of larger amounts in later years. It would have a favorable effect on interest rates in the first instance; I think it would have a favorable effect on confidence.

People have argued that maybe that favorable effect on confidence would outweigh the favorable effect on interest rates in terms of the immediate effects on the exchange markets, and the dollar might go up further. I think that is anybody's guess in the short run.

But I think you would have created an economic situation where the basic forces would work toward a better competitive equilibrium in the world, and you would have broken down in the process, I think, some blocks to growth abroad which would help redress perhaps an exaggerated pessimism about their prospects which is, in turn, affecting these capital flows.

Senator BIDEN. I thank the chairman and I thank the Senator from Maryland for indulging me.

The CHAIRMAN. Thank you, Senator Biden.

Senator Mathias.

Senator MATHIAS. Thank you, Mr. Chairman.

Mr. Volcker, you have repeatedly expressed a concern this morning about the current accounts deficit.

Just to put that into perspective, can you tell us what the highest historical current accounts deficit was before last year?

Mr. VOLCKER. I cannot, offhand. You would have to go way back in history. You may find some time in the 19th century when we were more literally a developing country, but I do not have that.

Senator MATHIAS. If I suggested to you $15 billion, would that shock you?

Mr. **Volcker**. $15 billion?

Senator **Mathias**. $15 billion as being the highest previous current account deficit?

Mr. **Volcker**. In absolute terms?

Senator **Mathias**. In absolute terms.

Mr. **Volcker**. It was $15 billion recently, and I think you are probably right, that is the peak, but of course I was thinking of it relative to the GNP.

Senator **Mathias**. No; I meant in absolute terms.

Mr. **Volcker**. In absolute terms, there is no question that we are way out of sight.

Senator **Mathias**. And I was really thinking in terms of current history, not 19th century history. But that indicates that it has multiplied more than six times, dramatically, suddenly.

Mr. **Volcker**. Yes; it is up by $100 billion in the last 3 years; from zero, roughly, to $100 billion.

Senator **Mathias**. And it is six times higher than we had ever experienced it in modern times.

So certainly that seems to be a warning signal, and I share your concern about it. I think we all have to consider it.

In your statement you refer to a subject that is of concern to this committee, and that is that the developing world needs to devote its own savings to its own problems and not to ship it out to us.

To what extent do you think our borrowings in Europe and in the developing world are restricting economic growth there?

Mr. **Volcker**. Our interest rates are a burden on their current payments, a very direct kind of burden, and so you have that road block put into the way. On the other hand, I think you have to say that the great growth in the American economy in the past couple of years has been of enormous help to them in terms of markets for their own exports and assisting this adjustment.

I think in terms of their capital flows, while our interest rates and other factors have aggravated, from their perspective, the capital outflow problem and made it more difficult for them to get money back. When you are looking at the developing countries, the overwhelmingly important question is what is going on in those countries; and it is confidence in those countries themselves rather than relatively small interest rate differentials and those kinds of things that affect flows among the industrialized world.

The question is whether they have confidence in their own policies and their own countries, whether the investment climate and the outlook there is such that their own business people, their own wealthy people, keep their money at home. This debt crisis was in considerable part, depending upon the particular country, a creation of a capital outflow from those countries rather than a current account deficit, although there was a mixture of both, but in some of the countries the capital outflow was enormous, and that outflow has stayed abroad.

People who put this money abroad by and large are going to keep the interest abroad, too, or the dividends, or whatever. So the capital is kind of a dead weight from the standpoint of those countries, and I think it is terribly important over time that these countries have policies that keep the new savings there and as much as possible attract back some of that foreign savings that they put abroad.

Our policies, our interest rates and all the rest, do not help, but I do not think it is the core concern when it comes to the question of capital flight.

Senator MATHIAS. I would agree with you that every one of these situations is complex in and of itself, and it becomes more complex as you relate it to surrounding circumstances.

Mr. VOLCKER. I might say that I do not think you can explain this big capital flow in the past year or two on the basis of a capital flight from the developing countries. That has been much less in the past couple of years and, on balance, their current account has improved greatly, by definition. They are borrowing less abroad. This capital flow is dominated, I believe, by flows among the industrialized world.

Senator MATHIAS. But what about the indirect effect of a situation? For example, one of the game plans for management of South American debt contemplated a minimal economic growth in Europe of 3 percent.

Mr. VOLCKER. In the OECD world I think as a whole, not just in Europe.

Senator MATHIAS. Yes; and it would be very difficult to manage South American debt if we did not have that kind of economic activity in OECD.

Mr. VOLCKER. That is true.

Senator MATHIAS To the extent that Europe or OECD is probably not going to get a 3-percent growth rate, or——

Mr. VOLCKER. The OECD should, I think.

Senator MATHIAS. Or barely.

Mr. VOLCKER. I think we did better than that last year, and I think we will do better than that this year. Japan is growing faster than that rate, partly with the help of all of their exports to the United States. We are growing faster than that rate, and there is growth in most European countries. It is just not fast enough to reduce their unemployment rate.

Senator MATHIAS. It hangs around that level though. Some of them are a little below, some are a little above.

Mr. VOLCKER. Most of them I think are a little below 3 percent, but not all that much.

Senator MATHIAS. Our policies which reflect on Europe then have an indirect effect on the developing world and the debt problem in South America.

Mr. VOLCKER. We have been a tremendous motive for this because we can look at the growth of Japan and the growth of Europe which has been more sluggish, and a good part of that growth is traced back directly to the improvement in their accounts with us.

Senator MATHIAS. Now, let's look at the other side of that coin. I think it is clear that we have had the greatest effect on whatever recovery has taken place in the rest of the world by simply recovering ourselves.

Mr. VOLCKER. No question about it.

Senator MATHIAS. What is the flip side of that if there is a slowdown in the United States?

Mr. VOLCKER. That is a real problem in terms of these countries in Europe, mostly with slower rates of growth; they are kind of implicitly or explicitly assuming that growth in the United States continues at a good rate of speed, and I think some of those expectations could be disappointed—and in Japan as well—if we had an abrupt slowdown.

On the other hand, I think it is also fair to say that there are flip sides in another respect. The drain on their savings and the related depreciation of their currencies, the sharp depreciation of their currencies vis-a-vis the dollar and the fact that that puts some pressure on their prices—although by and large they have done well on prices—is a factor inhibiting them from more home-originated, stimulating measures.

If you had a different set of conditions in several respects in the United States, you might have more room for homegrown expansion in those countries. But I think there is a risk. I think the dominant risk at the moment is that their growth would slow if ours did, too.

Senator MATHIAS. One of the factors that has set the stage for the current situation has been the dramatic decrease in the price of energy.

How do you assess the benefits and the costs of the lower oil prices in the world economy, because I perceive there are both benefits and costs.

Mr. VOLCKER. I think stability in energy prices or decline in energy prices is favorable over a period of time. It obviously helps the inflation side of the equation, and I think helps the growth side as well, partly because if you get a lower rate of inflation from that kind of a development, you will have more room for growth and lower interest rates and a lot of other nice things would flow from that.

I think that a sharp drop in oil prices, in energy prices is not all a plus in the short run. I think it is a matter of degree, and like any other change creates some dislocations. There would be an aggravation of financial strains that already exist, for instance, within the United States, in the energy business.

Some developing countries that rely upon exports of energy and oil in particular are, obviously, going to be impacted, and if the price dropped far enough, they could conceptually be impacted to the point where the possibility of maintaining normal debt service and experiencing growth and all the rest would be adverse.

And you have a somewhat asymmetrical situation in that respect. The developing countries as a whole, I think are about in balance now as oil exporters or oil importers. They are neither large importers nor exporters. Those that import would be helped.

A favorable situation would be made somewhat more favorable. That is not the same with a country that is hurt to the point of really creating a very severe strain, renewed strain on the external side, and on the debt side of the equation. There is kind of a discontinuity there.

Just looking at it broadly, I think over time lower energy prices are favorable, but an abrupt decline that would only be reversed in a few years would put you through a rather severe disturbance to no long-term benefit. That is sometimes the way markets work.

Senator MATHIAS. I see my time has expired. I just have one question. As a matter of personal curiosity, would you include oil imports in your ban on import surcharges?

Mr. VOLCKER. Not necessarily; particularly under those circumstances. But I look at that as a revenue and conservation measure, rather than a protectionist measure. And I think the world would look on it that way.

Senator MATHIAS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Mathias.

Senator Pell.

Senator PELL. Thank you, Mr. Chairman. I would like to follow up on that question. One thing that has always bothered me is when I see the high cost of tobacco products around the world and the dependence of many foreign governments on them for tax revenue and the minimal use we make of them. A pack of cigarettes should cost $1.75. The cigar you are smoking should cost about three times as much.

Have you ever thought of that as being a very good source of revenue?

Mr. VOLCKER. I won't rise to a point of personal privilege and say I think that is an area where I can't object to taxes.

Senator PELL. Do we agree that that could be a good fruitful source of revenue?

Mr. VOLCKER. I don't want to get into which tax is good or which tax is bad, but I would not suggest that that particular tax has any particularly adverse effect on the Senate. [Laughter.]

Senator PELL. Thank you.

What is the dependence of the United States on foreign capital? For example, what percentage of ownership of stocks on the big board are held for foreigners?

Mr. VOLCKER. It would be a small fraction. I don't know the statistics on that. I will look for that and try to provide it for the record.

What concerns me is the flow, not the outstanding amount. Let me give you a statistic that I think puts it in perspective. About a quarter of our total net investment, housing, business investment inventories, and the Government deficit, which is running to something over 11 percent of the GNP, is now being covered by foreign capital.

[The information referred to follows:]

Department of Commerce estimates of foreign assets in the United States totaled $781 billion at the end of 1983; additional inflows were $62 billion in the first nine months of 1984. The resulting foreign asset position was about 10 percent of the sum of estimated U.S. credit market debt and equity values. Foreign holdings of U.S. stocks (excluding direct investment, where foreigners hold more than 10 percent of the shares of a company) were about $97 billion and approximately 5 percent of current equity values. Foreigners hold about 14 percent of the publicly held U.S. Treasury debt.

Senator PELL. Thank you.

Going back to the question of the percentage amount, are those figures available on the amount of foreign investment in the United States?

Mr. VOLCKER. Yes; they are not ideal figures. These must be among the crudest figures in all of economics, and some of them are pretty crude.

U.S. liabilities to foreigners, I presume that covers stock as well, $650 billion at the end of 1983.

Senator PELL. Out of a total capital value of what?

Mr. VOLCKER. $5 trillion, more than that. There is $5 trillion of debt in the U.S. economy, and you have to add a couple of trillion of stock on top of that.

Senator PELL. So that would be, as you say, not a very great percentage?

Mr. VOLCKER. It is less than 10 percent, I would guess.

Senator PELL. How would you assess the risk to the United States if another nation declared a debt moratorium? Would that rub off adversely on us?

Mr. VOLCKER. It depends upon the country. I don't know what you mean by the word "moratorium;" we have had lots of moratoriums in a limited sense. Do you mean a repudiation, to take an extreme form?

Senator PELL. That's a permanent refusal to pay. A moratorium, to my mind, means more of a temporary refusal.

Mr. VOLCKER. Well, we have had a lot of temporary ones that have not been labeled "moratoria." I am just trying to grope for what situation you have in mind. A temporary inability to pay, while the country and the creditors and the IMF are working on the problem, isn't going to have a severe repercussion necessarily. And we have had some of those, and it is part of the solution in some sense.

Sometimes that is necessary, to have a pause while conditions are reestablished. That in itself does not necessarily have a sizable effect—not that we would like to see them—but sometimes it has been a part of this process of a country reorganizing its own policies and getting the debt rearranged in a way that can be paid, but always with the intent of paying and paying fully.

Senator PELL. What we call rescheduling?

Mr. VOLCKER. It gives rise to reschedulings and restructurings.

Senator PELL. Rescheduling really is a polite word for—not debt repudiation—but a debt moratorium, then?

Mr. VOLCKER. You know, all of these words are loaded, and people give them different connotations. It seems to me that is a necessary process and a constructive process if it is accompanied by the real economic measures that are designed to improve the economic conditions in the country so that they can sustain that debt burden.

And, of course, as Senator Mathias was suggesting, success in these efforts also assumes growth in the rest of the world, otherwise these countries do not have a chance.

It is never nice to happen. It always represents some kind of failure. But given the failure in the system, it is a way—maybe a waystation—toward remedying the situation. And that is basically the context in which we have been working; that, fortunately, interruptions in debt service of that kind now are pretty confined and mostly in quite small countries.

Mexico went through that kind of a period for a while; Brazil did; some of the others did.

Senator **Pell**. Thank you.

Finally, the Chairman has referred to the United States as being the engine of the economic recovery for the world. If GNP increase is less, as it looks as if it will be next year, the year after, will that have an adverse impact do you think on the general economic conditions outside the United States?

Mr. **Volcker**. I would think a decline in the rate of growth of the kind that most people have been estimating—say in the neighborhood of 3½ to 4 percent or a little more, which would be a decline from last year and a decline from 1983—is sufficient to maintain a sense of momentum and growth. The rest of the world would be getting less stimulus from the United States than it did before, but I don't think it is at all inconsistent with growth in the world economy, and maybe as much or more growth in the world economy this year as last year if you allow for a little more growth on their part.

The **Chairman**. Thank you very much, Senator Pell.

Senator Kerry.

Senator **Kerry**. Thank you, Mr. Chairman.

Mr. Volcker, in your comments in your formal statement to the committee, you warn us—and I think rightfully so—about the pressures with respect to international trade, on the creation of some economic nationalism and protectionism, and certainly moves by the Congress to do so.

And you point to the success of our policies with respect to developing nations as dependent on us not moving in that direction, and also to the need to reduce interest rates, by reducing the deficit, to make for that success posible.

What about developed nations? Does the reduction in interest rate in your approach with respect to protectionism hold with respect to problems like Japan, where we have a $37 billion trade deficit, $20 billion of which is automobiles alone? Will the interest rate approach have an impact on that, or do we take other steps?

Mr. **Volcker**. Yes. I think it would. These countries, by and large, Japan less so than some of the others, have had depreciating currencies, related to this capital flow problem. To the extent lower interest rates in the United States reduce that pressure, reduce the incentives for their savings to flow to the United States, I think many of these countries—and if their currencies were not so weak it would help their inflationary situation; they have done very well on inflation as it is, even with a depreciating currency they have done very well.

With that additional element of protection, so to speak, against any revival of inflationary forces, my own sense is that you would find them taking more expansionary measures at home, which in turn would feed back and help our trade position. Imports are not going to be shut off by any sense, but to the extent their economy grows at home, more of those resources are used at home, then they have more need for what we can export to them.

So I think it does very definitely work in the direction of correcting the imbalance with Europe and Japan. We have a huge imbalance with Japan, and I am not suggesting that is going to disappear simply by those measures.

Senator KERRY. But you think that kind of pressure with respect to their currency would still be felt to an appreciable degree with such a large disparity in the automobile sector?

Mr. VOLCKER. Well, I don't know whether you would expect any probable change in the Japanese exchange rate, in the yen exchange rate, to eliminate entirely the competitive advantages that they have in the automobile industry.

I don't know just how big those are. I think our industry can compete now in some areas of the market. It competes in all areas of the market. It is just a matter of degree. It certainly goes in that direction.

Again, the more of those cars they sell at home, the less eager they are to sell them to the United States, and that is part of the problem. The market has been here, rather than at home.

Senator KERRY. You mentioned the question of currency valuation. You say also in your comments, that there is a role to play with market intervention at the appropriate moments, but you don't really discuss what those might be, and suggest that it is much more important to move on the deficit.

And I would agree there is obviously that need. But I wonder if you might describe to the committee a little bit where that role in today's marketplace dynamics might be imposed, and whether or not this is not a moment that we shouldn't also be pursuing that in ways that we are not.

Mr. VOLCKER. I think that intervention may be useful at specific moments when the market may appear to be moving inconsistently—or to a degree, at least, inconsistent—with more continuing forces. And I suppose that question is raised by recent developments, and there has been some intervention, as you know. It becomes a matter of judgment as to the degree and precise timing, and I would hate to try to write a rule book for that.

There have been many efforts to write a rule book, all unsuccessful through the years, and I don't think I can pronounce precise guidelines this morning.

Senator KERRY. You would not feel that a 30-percent overvaluation, coupled with the problems that we have with the VAT [value added tax], which really puts us almost at a 50-percent disadvantage before we even start to compete in terms of the quality of product, you don't think that kind of starting disadvantage might merit some kind of selling of dollars or intervention of some kind?

Mr. VOLCKER. The question is to what degree it is going to be effective. You talk about that kind of differential, which I am not at all sure I would agree with. I don't want to associate myself with the thought that we have that degree of overvaluation. But you are not going to correct, permanently, that kind of discrepancy, however defined, by intervention alone.

It is a matter of getting the basic policies right.

Senator KERRY. I absolutely agree with that. What I am wondering is what level of overvaluation you would——

Mr. VOLCKER. The question is what you mean by overvaluation. Some people would say it's not overvalued now because the market is what the market is. How do you know what is overvalued or not?

Congenitally, I am going to like a strong dollar in general terms. I think it is a sign of a healthy economy, an economy in which people have confidence and all the rest. There are matters of degree involved, and certainly the present level of the dollar doesn't look consistent with more equilibrium in our trade position, but there are two ways of correcting that.

One is by increasing our internal competitiveness and productivity and all the rest, and having a good inflation performance over time. The more we can do on that side, the better off we will be.

And to the extent there is more confidence in foreign economies, which would be another healthy kind of development in the interests of the world, that might in itself be reflected in less of the recent kind of apparent distortion we have had.

Senator KERRY. Obviously we are undergoing a tremendous amount of pain here in making some choices about cuts in order to deal with the deficit, and as long as the pressure is on with respect to the deficit, that pain has to be inflicted. But if there are some alternatives available to us that might in fact reduce some of that pressure, I wonder if it isn't a choice that we shouldn't be making.

Mr. VOLCKER. I don't think that those alternatives are there. I think intervention can be useful at particular times. It is just not a tool that at all is comparable in magnitude or force or lasting influence as dealing with such a basic problem as a budget deficit.

The other alternative that arises, which may have been hinted at by the chairman earlier, was monetary policy. And again, I would have to tell you, monetary policy is a pretty fundamental instrument. Bad monetary policy is no substitute for good budgetary policy. And that, in effect, is the way the question comes at you to some degree: Can't you carry out an inflationary monetary policy to get over this pain with the budget deficit?

In fact, I would judge from where I sit, that part of the difficulty in dealing with the budget deficit is that there isn't all that much apparent pain at the moment. I think a lot is there in the agricultural area and heavy industry and so forth. How much of it is associated with the budget deficit, I don't know. Politically, probably not very much.

But the pain is there. And the pain could be sharply aggravated at some point if we don't deal with our problems effectively, if these capital flows were to stop.

Senator KERRY. I see my time is almost up. I just want to ask you, with respect to the overall budget reduction efforts and the deficit, you have pegged this $50 billion which has caught momentum, I think subsequent to your not insignificant blessing of that figure. I wonder if you could say whether there is a ratio of any kind that one can look for in terms of deficit to rate of growth? I assume we get enough restraints in the rate of growth in major programs here so that we can look to a long-term line that shows growth versus expenditure in a satisfactory relationship. Is there then a level that you might be able to say, given those assumptions, that one can look to, that one can accept in the deficit if we are growing well enough and those other restraints are there?

In other words, do you have to go down to zero? Can you settle for $25 billion, or $15 billion?

Mr. VOLCKER. My answer has to be that I am old-fashioned enough so that in the context of a prosperous general economy, that level ought to be zero.

Why have we forgotten so completely about the virtues of a balanced budget in the context of a prosperous economy where we have a lot of need for investment and all the rest?

You know, people say "Well, some deficit would be sustainable," and in some sense I suppose that is right, though maybe not preferred. But when the additions to the debt are not faster than economic growth, where we are adding to the debt at 16 percent and growing at 4 percent, that is a little disproportionate.

Suppose you got it down to only a 4-percent increase in the debt. We are so far from that that I think it is beyond the practical realm of what you can do in the short run, or even should do in the short run.

Senator KERRY. I understand that. Mr. Chairman, I know my time has expired. Could I ask your indulgence just to follow through quickly on one piece of that?

I accept that the goal of trying to achieve zero is what we would want to do. But my question is this: If we are on a track where the line of growth versus increased expenditures is such that although we don't get to zero in 4 years, we get to zero 10 years from now or 12 years from now by virtue of a combination of cuts and growth, including cuts today significant enough that you can say the deficit is going to be reduced, without added expenditures in military or elsewhere to compound the problem, why isn't that acceptable?

Mr. VOLCKER. You are obviously better off than you are now. When you talk about a pattern that is going to produce a balanced budget 10 years from now, I don't think that in itself is going to, shall I say, have much credibility. Nobody can predict 10 years ahead, and there have been lots of projections of balanced budgets years into the future, and they never materialize.

I don't know how you could produce confidence that that would, in fact, be the result over a 10-year period. I think you have to look at this in a somewhat closer perspective. You take what action seems possible and enough, in some shorter term sense, this year; hopefully, that action will have multiplier effects in and of itself in following years. Most of these actions will compound upon themselves, but you have to come back and look at the situation next year and say how much more do we have to do against some reasonable scenario, which I think is going to have to be much shorter than 10 years to have any reality to it.

Senator KERRY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Kerry.

Mr. Volcker, I know that you have some time constraints, but I would like to have just one more round of questions with Senator Cranston who has entered.

Senator Cranston, would you please raise your questions?

Senator CRANSTON. Thank you very much. I just have two questions, so you won't have to take too much time, I trust.

The Nation, as we are all aware, is having major problems with exports because of the high value of the dollar. And that is a particular problem in my State of California where we are No. 1 in exports of agriculture, manufactured goods, and high technology products among others.

Can you give us any specific suggestions as to how our tax and savings policies could be improved to help U.S. exports be more competitive?

Mr. **Volcker**. I should make a preliminary statement that exporters are under pressure, and I don't want to deny that general statement. But they have done surprisingly well considering all else that is going on. We have actually had an increase in exports.

I think the more basic policies that we are talking about are going to be more effective than anything we can specifically do for exports, by export credits, by particular tax incentives, and that kind of thing. I don't have any very strong suggestions along that line of particular measures.

In fact, two of the particular measures that I have had some interest in in the past, the so-called DISC arrangement and export credit facilities, have been cut back recently. Again, I don't think those measures are of absolutely critical importance compared to some of these more basic things. It is related to the budgetary problem. You get all kinds of conflicts here in policy, but just looked at strictly from the exporting side, I am not sure those actions help.

Senator **Cranston**. The other question I would like to ask you relates to an issue that you discussed with the House Banking Subcommittee yesterday. I would like to read two paragraphs from the Post story that you have undoubtedly read this morning.

> Volcker said that the current situation in which more than $100 billion worth of foreign capital is flowing into the United States annually in excess of that being sent abroad by Americans is an unstable and risky one. "The incentive to put money in the United States could prove quite fragile" to a shift in expectations about future inflation in interest rates, he warned.

Again quoting you:

> "We are hostage to, we are hooked on foreign capital for a while" because of the large budget and trade deficits. The price of that dependency is that "if we cannot get so easily the foreign capital we need, then interest rates will rise" and domestic credit users such as housing and investing businesses will get credit out of the market. "That's the risk," he said.

How do we deal with this problem where, on the one hand, the current high interest rates, to the degree that they are high, are attracting foreign capital, the seeming stability of our economy compared to that of other countries is attracting foreign capital? I guess that is helping us finance the debt. If we didn't have that, we would be in trouble over the debt and we might have higher interest rates, but less stability and difficulty for you in terms of what you do about the money supply.

Mr. **Volcker**. That is my story.

Senator **Cranston**. How do you balance these competing interests?

Mr. **Volcker**. I just simply know no answer to getting out of what I think is a dilemma. We hate the trade deficit, and we love the capital inflow, but they go together.

I think the only way you can escape this is to go to the source. You could go to monetary policy if we were in the middle of a recession now and say, "Well, why are interest rates so high; can't you stimulate the economy some more?"

But the economy is doing well. It is growing. It is a prosperous economy overall, despite all of the problems. In this situation, I think you have to go basically to fiscal policy and say why are we in this jam? We are in it because we are borrowing more at home—both for the budget and for investment and for housing and for inventories. We are borrowing more than we are saving by a very significant margin.

We are borrowing about 25 percent more than we are saving, so we are going abroad to pick up that difference. You can increase the savings rate. If you have some magic way to increase the savings rate, that's another way to escape the problem. But I don't offer any real promise that you have, or could devise, or that anyone could devise short-range measures that are going to have that kind of pronounced impact on the savings rate. It is a very stubborn kind of behavior that accounts for our savings.

Savings right now have been given a lot of incentives, but savings are still in the same general channel that they have been in relative to income for many years, so I don't see much prospect on that side. We don't want to cut back investment. We don't want to cut back housing.

I am trying to eliminate all of the possibilities. I don't think I have left any but action on the deficit.

Senator CRANSTON. Is the main reason that we are not paying a normal and expected and predictable price for these deficits the inflow of foreign capital?

Mr. VOLCKER. Yes. I think it is an illusion. We are paying the price. We are not paying the price in the housing industry in a pronounced way, which is the classic area that gets squeezed by a shortage of savings relative to investment. Housing gets squeezed and then investment.

It has not worked that way this time because your exporter has gotten squeezed and the guy competing with the importer has gotten squeezed.

Senator CRANSTON. It is a real dilemma. Thank you very much.

The CHAIRMAN. Thank you very much, Senator Cranston. And thank you, Chairman Volcker. We very much deeply appreciate your testimony and your forthcoming answers to questions.

Mr. VOLCKER. Thank you.

The CHAIRMAN. The Chair would now like to call upon: Mr. Richard A. Debs, president, Morgan Stanley International, Inc., of New York; Mr. George J. Vojta, executive vice president, Strategic Planning, Bankers Trust Co. of New York; and Mr. Donald Tanselle, president, Merchant National Corp., Indianapolis, IN. Gentlemen, would you come to the witness table.

[Pause.]

The CHAIRMAN. Gentlemen, we deeply appreciate your coming to this hearing this morning. Let me state for the record that the prepared statements that you have submitted, will be made a part of the record. Let me ask if each of you might either give a portion of your testimony or a summary of your testimony, in about a 10-minute period each, and then the panel will be subject to questions from members with a 10-minute time limit for those questions after your testimony.

I would ask that you speak in the order that you were introduced this morning: first Mr. Debs, then second Mr. Vojta, then third, Mr. Tanselle.

Mr. Debs, would you please proceed.

STATEMENT OF RICHARD A. DEBS, PRESIDENT, MORGAN STANLEY INTERNATIONAL, INC., NEW YORK, NY

Mr. DEBS. Thank you, Mr. Chairman.

I think one of the main points that I have made in my testimony has really become moot by the conversations we have had this morning in these hearings by the committee with Chairman Volcker, and that is that I see no difference between what we have known as international economic policy and domestic economic policy.

You simply cannot treat them separately. The world has changed considerably over the past few years, over a relatively short period of time, actually, and our domestic economy today—our domestic policies have an impact on our friends and allies abroad, their economies, which in itself is a cause for concern and always has been.

As we have said in the past, when the United States catches a cold our allies get pneumonia sometimes. But in more recent days, with the interdependent world we have had, that pneumonia can come back to us. If we do not pay attention to the health of our allies, which as I say is important in itself, our domestic economy can be very greatly affected.

As I say, this has not been the case, but there has been change, tremendous change in the last few years, and the statement has indications—you are familiar with them all—of how imports have increased as a proportion of our GNP, how foreign savings have become such an important part of our own domestic economy in terms of savings flow. Chairman Volcker this morning mentioned a figure of one-quarter of our flow comes from abroad.

The other aspect of this is that this integration has affected the different sectors of the economy differently, and in our own sector, that of the banking and financial community, it seems clear that the world is indeed one in that respect.

We often hear talk about being on the verge of a new era of a worldwide capital market, a global capital market. Well, that kind of talk is wrong because we are there right now. The ripple effects within the financial communities, whatever actions are taken, are felt throughout the world and pretty fast.

One point I made in my statement, and one that I would like to simply state is that there is room for much better coordination within our own Government between domestic and international economic policy.

How one would address that problem, I am not sure. There has been talk of a Department of Trade, for example, to coordinate international trade policy. That has been controversial in many respects. I think it should go beyond that. We need coordination of all of our international economic and financial policy, not simply trade, and all of our agencies, as well as committees of the Congress should be sensitized to this need to look at both sides of these policy considerations.

Another point is that consultation with our allies is crucial. It is not just crucial for foreign policy reasons or for international economic reasons. It is crucial because it affects our own domestic economy, our own citizens at home.

The summit meetings, which have been in many respects, cynically critized for not doing much, are a very good step in the right direction. They focus a lot of attention, a lot of concern on problems. They create an interchange that is extremely valuable. My only hope would be that there would be some action taken as a result of them. That does not often happen, but clearly that is the right step.

I would like, in terms of looking just at examples of where these concepts might fit in, to look at two areas that I have in the statement. I will not go through them at length. One is the problem of our current account deficit. The other is the problem of the LDC debt.

On the first, I characterize it as current account deficit and not the problem of the dollar because there is not unanimity that the dollar is indeed a problem, as we have heard in this morning's discussions. However, it is very clear that the current account deficit is a problem and will become more so. It will become an acute one if it continues on its present course.

I think Senator Mathias' comments on the relative size of this last year's deficit versus anything before that historically are very pertinent. If it continues at this kind of rate, we will hit half a trillion dollars in a few years. And just taking an assumed 10 percent interest rate, that will cost us $50 billion alone on that item on interest costs.

That and everything else that goes with it—the underlying reasons for having this kind of deficit, the question of our importers, exporters, and so forth—are indeed a problem.

Again, it seems clear to me, it seems very logical, that if the dollar, which is an immediate cause—there are many other causes of the current account deficit, not the least of which has been our growth, the attraction of investment here to foreigners, the relatively weak performance of their economies, and so forth, but clearly the dollar is a very important element in that current account deficit.

And if that is the case, you would think we would have a policy that would address itself to the foreign exchange value of our currency. For a while we left it to market forces. We had this regime of benign neglect. That did not seem to work so well.

The Fed, as witnessed by Chairman Volcker's testimony this morning, is paying more attention, giving more consideration, more weight, to the exchange rate of the dollar in monetary policy. Clearly that is all in the right direction, but I do not think that it has really gone far enough within our Government.

I have commented on some aspects of what might be involved in focusing more on that kind of problem. I think really the main point is that we should focus on it both in terms—well, not only in terms of monetary policy, but fiscal policy, the budget deficit.

Clearly there is a link, a strong link, between the exchange rate of the dollar, our domestic interest rates, and the budget deficit. You get people who disagree on the strength or directness of that link, but clearly it is there. And you cannot discuss current account deficit, the strength of the dollar, without focusing on not only monetary policy, but the budget deficit itself.

In the problem of the LDC debt, it is a broad subject. I have put in some rather detailed figures on the case of Mexico, which is a good example, I think, and hopefully a precedent for future progress. They have done in many ways a remarkable job.

You have heard all of the good figures on Mexico and they are extraordinary, but one that is important to keep in mind is that wages earned, real wages, have dropped about 30 percent over the last 2 years in Mexico. That is a measure of the pain that some of these internal programs have to generate in order to reach success. It is something that I think cannot go on. We cannot expect them to have to go on too long.

I might say that there is clearly—there must be continued lending by the commercial banks. There must be restructuring, continued restructuring. But also, we have to look at alternative sources of financing for the LDC's beyond the traditional syndicated floating rate type loans. I happen to be chairman of a committee under the Group of Thirty who are looking at this right now, looking at what these alternatives might be.

Senator **Mathias**. Arthur Burns will chair. He has been advocating this for a long time.

Mr. **Debs**. I know he will. And we have to search everything. We have to look at every possible alternative, and we are trying our best.

One question one might ask is, why are we so concerned with the LDC debt? Why? Really, it is an external problem. There are clearly answers. There are humanitarian answers, there are political answers, military answers. We do not want to see our allies weakened, basically. We do not want to see them taken over by hostile regimes.

But more than that—and again, on the main point—a very important reason for our concern is that their economies affect our own. About 40 percent of our exports have been to the LDC's, and I think 1 out of 20 jobs depends on sales to the LDC's.

The impact on our own financial system is closely linked with the LDC's. So it is not simply a question of what has been known as foreign policy in the old days. It is a question of domestic economic health in the United States, of making sure that they get through.

I would say that, looking again at what we have been trying to do in these alternatives, there is a lot to be done. But when you get down to it, looking at possible amounts, we have not concluded yet what they might be in terms of size.

Official sources are going to have to play a major role in this problem. The IMF, as you know, has been critical in this. The World Bank has a very important role in longer term development. I think that they need support. I think that they are very important to us in terms of our own policies.

Unfortunately—and you will remember in the hearings a couple of years ago at the IMF replenishment—there has been some debate in public, in some quarters anyway, about the usefulness of those institutions. That is very unfortunate.

I appeared in support of the legislation, as well as the IDA legislation, with you, Senator Mathias, on behalf of the U.S. Chamber of Commerce. Without getting into all of the issues involved, the chamber supported those bills, still supports those bills, because the chamber, which as you know is broadly representative of the U.S. business community, the chamber believes it is in the best interests of the U.S. business community, not for foreign policy considerations, which is beyond their ken, but because of our own parochial interests, that those institutions be strengthened.

Senator MATHIAS. You need to say it again.

Mr. DEBS. I will keep saying it, Senator.

I would say that there are ways that they can be improved. Operationally, there are a lot of things that can be done. One of the things the chamber is looking into is how U.S. businessmen could take better advantage of business opportunities that come up through their operations. One thought we have had is that the executive director on each of these institutions might be given a mandate to assist in that regard, to help to think about the American business interest.

But whatever the case, longer term I am certainly convinced that they must play a very major role, not only in the LDC debt problem, but really they provide a good vehicle at low cost to the U.S. taxpayer for this coordination and cooperation on the international economic side.

Thank you. I think I will stop right there.

[Mr. Debs' prepared statement follows:]

Statement
on
The Future of American Foreign Policy: International Economic Dimensions

before the
Committee on Foreign Relations
of the
United States Senate

by
Richard A. Debs
President, Morgan Stanley International Incorporated
February 27, 1985

Mr. Chairman and members of the Committee, I welcome this opportunity to participate in these hearings on the international economic dimensions of the issues covered in your general review of the future of American foreign policy. The subject is as broad as it is important, but I will attempt to highlight in this statement only a few basic issues, recognizing that the Committee would like to allow adequate time for an exchange of views at this hearing.

One very basic point I would like to make is symbolized by the fact that your Committee is devoting a significant portion of time in its general review of foreign policy to the economic and financial dimensions. The formulation of foreign policy must indeed take into account international economic factors if it is to be effective. In today's world, there is no way that we can successfully address international political problems without giving full weight to the economic issues; nor is there any way we can address international economic problems without considering the political issues. I am no doubt stating the obvious to this Committee, but unfortunately it is a truism that is often neglected in the way we run our government. To say the least, there is substantial room for improvement in the coordination and understanding of the political and economic dimensions of foreign policy within the government in general, and the efforts of this Committee in focusing on both aspects are to be applauded.

By a similar token, there is a need for substantial improvement in the way we approach international economic financial policy issues. We tend to think in terms of international versus domestic economic policy. There is no such distinction in the real world today. The national economy of the United States is no longer separable from the rest of the world. It is true that we have recognized for some time that the policies of the U.S., as the leader of the free world, have a crucial impact on our friends and allies. As they say, when the U.S. gets a cold, the rest of the world could get pneumonia. What has not been as well recognized, however, is that the domestic policies of the United States have international ramifications which in turn have a direct impact on the U.S. domestic economy. We can catch pneumonia back home if we are not careful about the health of our friends abroad.

This was not always the case. Foreign trade, for example, was never an important part of our economy until recent years. Two decades ago, total imports were about four percent of GNP; that percentage has since more than tripled. Today, imports alone have reached the level of about $427 billion, or about

12 percent of GNP. Out of every dollar that Americans spent for goods last year, twenty cents went to buy imports. On the export side, in recent years about 40 percent of our agricultural production has gone overseas. Clearly, any U.S. domestic policy action that affects foreign importers will also have a direct impact on U.S. exporters-- for good or bad. As we have also seen in recent years, the level of foreign imports can also have a dramatic effect on our domestic inflation rate.

Apart from the area of trade flows, the inter-relationships between domestic and international economic policy are also manifest in capital flows. One telling statistic is a recent Federal Reserve estimate that last year about one-third of the total savings flow in this country came from foreign sources. Is that a subject for domestic economic policy or international economic policy?

Apart from measures of trade or capital flows, it is also obvious that in some sectors of our economy, such as the financial sector, it is virtually impossible to think in terms of domestic policy versus international. With the well-advertised processes of "deregulation" in the United States, "liberalization" in Japan, and "financial revolution" in the United Kingdom, together with the improvements in telecommunications that have occurred, banking and finance are indeed global industries. The ripple effects of market forces in New York are immediately felt throughout the world's financial centers, and are transmitted back through the entire U.S. financial community. In our own business, trading is conducted around the clock through our offices in London, New York, and Tokyo, with each in close communication. There are those who say that we are on the verge of entering a new era of integrated global capital markets. They are wrong. We are there now.

If this is the case, if the free world economies in general are indeed interdependent and increasingly integrated, it seems to me that the basic question for us in the U.S. is how we should best manage the new circumstances as the leader of the free world. I would suggest two areas to focus on: first, a closer integration and coordination of economic policy, both domestic and international, within the U.S. government; and second, the closer integration and coordination between our policies and those of our allies and friends abroad.

An example of the first is the ongoing discussion concerning the establishment of a new Department of Trade, to give a higher priority to international trade policy. That sort of thinking is certainly aimed in the right direction; but controversial as it is, does it go far enough? Is there some merit in thinking in terms of a White House equivalent of the National Security Council that would focus on world-wide economic and financial issues, not just international trade? Such an office would have a responsibility for ensuring that proper weight is given to the international dimensions of our economic policies, including fiscal policy, trade policy, agricultural policy, and whatever other policies may have an impact on-- or are impacted by-- international developments. In the absense of any such dramatic organizational changes, some improvement in coordination could be achieved by encouraging the various departments and agencies of the government to give greater weight and focus to the international economic and financial issues. One example that comes to mind in these hearings of your Committee is the State Department, which could make a stronger contribution in these areas.

On the second point, consultation with our allies and friends on economic policy, it appears that there has been a start-- albeit a late start-- in that direction, but there is much more to be done. Despite some cynical judgements as to their worth, I think that the Summit Meetings have been a very useful step in the right direction. They serve to focus attention, information, and concern on these problems, and underline the need for more cooperation in their resolution. And it seems clear to me that the resolution of some of our problems can only come by international cooperation and consultation-- which in turn may require accommodations in what might otherwise be considered the province of domestic economic policy. In today's integrated world, such accommodation may be essential to ensure the health not only of our partners' economies, but of our own as well in the longer run. I would think that your Committee would be interested in considering further how these consultations could most effectively be used to support the economic objectives of our foreign policy.

So far, I have spoken only of general concepts and directions. I would like now to review briefly two general problem areas for international economic policy-- important in themselves, but also as examples of where these concepts might apply. The first is the problem of our current account deficit; the second is the LDC debt problem.

But before getting into problem areas, I should say first that our economy, in very general terms, seems to be in good shape at this point. We have certainly made dramatic progress over the past few years in resolving some of the more acute problems that have faced us, primarily on the domestic front: dampening inflation, reducing unemployment, and increasing growth. In many respects our progress in these areas has been remarkable. There is concern, however, that we may be at an equilibrium point,where the progress we have made may be thrown off balance by countervailing forces, many of which may be generated by the international dimensions of our economic policies.

With respect to the first problem area I cited, I would note that I characterized it as that of the current account deficit, and not the problem of the dollar. I do that because there is not unanimity in the United States that the dollar is indeed a problem. That in itself may be a part of the problem. There is, however, general agreement that the current account deficit is a problem which will become increasingly acute if it continues on its present course.

As the Committee knows, the current account deficit reached $100 billion in 1984, which represents an unprecedented level of 2.7 percent of GNP. This deficit, unlike the domestic deficit, must be financed by foreign countries and represents an additional $100 billion in claims by foreigners against future U.S. production. At the rate we are going, the U.S. will be soon in the position of a net debtor country to the rest of the world.

What are the implications of this? There are many, few of them good, but just consider one single fact. If we were to continue at the present rate of increase in the current account deficit, we could reach a cumulative figure of $500 billion in external debt in a few years. At an assumed 10 percent interest rate, this would mean that we would have to pay foreign holders about $50 billion per year in interest costs on this amount alone. Think of the impact this would have on our domestic budget deficit.

Quite apart from the debt burden, we must also consider the domestic problems that underlie such an enormous current account deficit. Our exporters, which include farmers and small businessmen as well as our corporate giants, are seriously feeling the pinch of having their overseas markets closing down on them because of the high price of their goods in dollars. On the import side, we have problems as well. Obviously, lower priced imports are beneficial to U.S. consumers in the short run, and it is also true that our domestic inflation rate has been suppressed by the lower priced imports. However, the impact on U.S. producers for the domestic market-- quite apart from U.S. exporters-- must also be taken into account. Those whose products are in direct competition with lower cost imports are obviously bearing the heaviest burden; and the adverse consequences are not limited to lower corporate profits, particularly where workers must be laid off. There are other side effects as well. For example, one of our Morgan Stanley studies shows that imports of capital goods have increased disproportionately faster than imports of consumer goods, and that about two-thirds of these capital goods imports have been in technology items, an area in which U.S. producers have been thought to have a substantial competitive edge. As a result, despite the surge in capital spending in the United States that we have recently witnessed, domestic producers have not gotten the full benefit of that increase, but have seen their market share drop sharply as a result of import penetration.

One perceived remedy to this kind of problem is seen to lie in tariffs, import surcharges, import quotas, domestic content legislation, the whole array of protectionist measures that are so tempting as immediate solutions. That, in itself, is a major part of our problem. Clearly, protectionist measures, in anything but the short run, are self-defeating. They simply do not work in the longer run, and worse, they can seriously aggravate existing problems by world-wide "beggar-thy-neighbor" policies which run the risk of global recession if they get out of hand. Rather than treat symptoms, which protectionist measures are aimed at, we should try to treat the cause.

What, then, is the cause of current account deficit and the problems it generates? There are many causes, not the least of which is our recent strong record of growth, the relative weakness of the economies of our trading partners, the relative higher levels of domestic interest rates, all of which are reflected in our strong dollar, which is in turn an immediate cause of our growing current account problems.

Going back to the question of coordination of domestic and international economic problems, and assuming that the level of the dollar has important implications for both our own economy and the economies of our allies, it would seem logical that we should give significant weight to the foreign exchange value of the dollar in our policy considerations. There is not much evidence that we have.

For a while, we left the matter entirely to market forces, under a regime of "benign neglect". That did not seem to work too well. More recently, there have been indications that we do have some concerns about the dollar, even to the extent of agreeing, at the G-5 meeting in January, that more intervention in the foreign exchange markets might be appropriate. Also, in formulating monetary policy, the Federal Reserve has indicated that more weight is being given to the level of the dollar as it may be affected by our domestic interest rate levels. There is also expressed hope from official quarters that if the dollar should reverse direction, it will not come down too sharply, or that it will have a "soft landing", thus avoiding what everyone seems to agree would be a serious disruptive consequence. But there is no indication of any policy course to help ensure that result.

All of these indications of concern are welcome, but they hardly go far enough in view of the magnitude of the potential problems facing us, whether they be described in terms of current account deficit, or a strong and rising dollar, or even a dollar that may be about to fall precipitously.

It is difficult to lay out a blueprint for what a dollar policy would entail. Foreign exchange intervention, for example, can be a useful supporting tool in the right circumstances, but it is by no means a solution, and in any event has been a red herring in the debate on the question. It diverts attention from the core issue, and that is a willingness to focus on the exchange rate of the dollar as one of our policy objectives. What is needed is a policy focus on the fundamentals of our domestic economic policies and the implications they have for our currency, and in turn, on the implications of the dollar exchange rate for our domestic economy. There is certainly a strong link, for example, between the dollar exchange rate and domestic interest rates; there is certainly a strong link between our domestic interest rates and our domestic budget deficit. Views may differ on the strength or directness of those links, but no one should disagree that they exist. It would seem to me that, in the formulation of both monetary policy and fiscal policy, much more weight should be given to the international ramifications of our domestic actions. This is where a top level policy group with a mandate to focus on the international aspects of all of our domestic policies could serve a most useful role.

In a similar vein, international consultation and coordination with our allies is also crucial in this interdependent world. At the present time, our allies feel that they are constrained in stimulating growth in their own lagging economies by our relatively high dollar/high interest rate levels. On the other hand, there is much that they could do themselves to restimulate and restructure their economies-- an objective we both share as desirable. There is a limit, for example, as to how far we can help some European economies with their chronic unemployment problems, no matter what we do with our domestic policies. In any event, what we need are regular channels for international consultation and coordination, based on the recognition that we have problems in common with our allies in the free world that affect not only international relations with them, but the economic well-being of our citizens at home.

Now I would like to turn to the second problem area I mentioned, that of the LDC debt. It is a broad subject, and I intend to limit my remarks here to the general theme of what I have been attempting to say about the coordination of our international and domestic policies.

As you know, public perception of the LDC problem has gone through several phases. It took a while to recognize; then it was seen as an imminent crisis that would destabilize the free world economies; then it was perceived as practically resolved; and in recent weeks, there has been concern that its resolution would unravel, and lead to crisis again. It has also been an exercise of placing blame on various culprits for creating the problem: the LDCs for profligacy; the banks for greed; the IMF for unconscionable austerity; and the U.S. Government for brutally high interest rates.

None of these perceptions have been very helpful. The fact is that all of the parties concerned are engaged in a long hard effort to work out a long-term solution that will see significant real growth restored to the LDCs, their credit-worthiness reestablished, and the banking system remaining intact. These goals are achievable, but only with hard work, a heavy continuing burden on the peoples of the LDCs, and a dedication to its success by all parties concerned.

So far much progress has been made, and the parties concerned in general, have been dedicated and constructive in their approach to the problem. The case of Mexico is perhaps the best example of, and hopefully a precedent for, the progress that can be made.

Mexico was the first country to encounter the LDC debt problem about four years ago, and the first to undertake a program to deal with it. It involved their own internal adjustment policies, an IMF program, and a continuation and restructuring of their borrowings from their commercial bank lenders and other creditors. The total external debt is now about $95 billion, including official credits. The size of the IMF program is about $3.9 billion over three years, and the IMF program itself has served as a catalyst for an overall financing package, including restructuring of commercial bank loans as well as other debt, of about $70 billion. A major part of the commercial bank program, about $48 billion, is now being negotiated, and they are hoping to conclude it by the end of March. Most of the debt will be lengthened in maturity out to 14 years, which, together with other changes in terms, will lighten the annual debt service burden considerably.

In order to reach this point, the Mexican government undertook an internal program which has been as difficult as it has been successful. The budget deficit was reduced from 18 percent of GDP in 1982 to 7 percent in 1984; inflation dropped from 100 percent to 59 percent in the same period; economic growth went from 0 to 3 1/2 percent per annum; and from 1981 to 1984 the current account balance swung from a deficit of about $13 billion to a surplus of about $4 billion, primarily by cutting down imports. All of this was achieved at great cost, however, in terms of living standards in Mexico. Real wages, for example, dropped about 20 percent in 1983, and a further 10 percent in 1984. Although the government's policy is to stop any further erosion in 1985, this 30 percent loss to wage earners in two years will not be made up. It is a dramatic measure of the sacrifices required to undergo a program of this kind.

The other major LDC debtor countries, such as Brazil and Argentina, are in various stages of the process. It goes along haltingly, with setbacks from time to time, but so far the progress has been satisfactory.

Looking ahead, it is clear the the LDCs will need additional new funding to implement their economic programs. It is also clear that there are limits to the amount of funds that the commercial banking system will be able to provide, or that the LDCs themselves will be willing to incur, in the form the traditional syndicated floating-rate bank loans. Accordingly, much attention has recently been focused on possible alternative forms of financing for LDCs apart from these traditional bank loans. One of these studies is being conducted under the auspices of the Group of Thirty, and I am chairman of the study group now looking at this question. We are studying a wide variety of possible alternatives, ranging from innovations such as interest rate or currency swaps, to the possible use of the capital markets-- bonds or equity issues-- to a reemphasis on direct investment. We are also studying how the official international agencies, such as the World Bank, the IMF, the IFC, and the regional development banks, might be used to support or supplement participation in these private sector initiatives. We will also be looking at similar roles for governmental agencies such as the Export Import bank or OPIC.

We believe that these alternative sources and mechanisms hold some promise, but we do not yet have a firm idea of the magnitude of the funds available through these alternative channels. In any event, we are certain that the process of developing them in any significant size will take time-- perhaps more time than is available to solve the problem without further hardship.

In looking at the problem from the point of view of the United States, it would be useful to ask the question: why are we concerned with it at all? For various reasons, obviously. For humanitarian reasons, we do not want to have our friends suffer the conditions of protracted recession, with already low living standards dropping even further. For political reasons, we do not want to see democratic governments toppled by Communist groups who prey on the misery of the poor. For military reasons, we don't want to see our allies weakened.

But beyond these external considerations, there are weighty "domestic" policy reasons that are just as compellling. For one thing, the LDCs are very important trading partners for us. More than 40 percent of exports of U.S. goods and services, and one in twenty manufacturing jobs depend on sales to LDCs. Because of their debt service burdens and their resulting austerity programs which require cutting down imports, together with the strong dollar, our exports to them have been reduced dramatically. For example, a few years ago our exports to Mexico were around $18 billion, with imports at $12 billion, resulting in a $6 billion favorable balance. Today, it has been reversed, and we are exporting $12 billion against $18 billion in imports, with a $6 billion unfavorable balance. That is a swing of $12 billion, which is a significant piece in the total picture of our international trade.

Another "domestic" reason for our concern about the LDC debt problem is the health of our banking system. It is not fruitful to discuss here whether the banks were negligent or somehow at fault in getting themselves into the position they are now in. The relevant consideration is that if the LDCs are not able to service their debts to the bank, or if there are major defaults, the consequences for our banking system would be most harmful indeed. In view of the key role the banking system plays in our national economy, it would seem foolish not to extend our best efforts to solve the LDC debt problem on these grounds alone, regardless of why we are where we are today, or how we got here. That is a separate question.

Again, to restate the main theme, the LDC debt problem is important to the U.S. not only because of its foreign policy considerations, but because of what we perceive as purely domestic considerations as well. Which again, I think, makes the point that in today's world you cannot separate the international dimension from the domestic. The transmission of effects runs both ways, of course. The LDC debt problem has a direct impact on our domestic economy; but our domestic economic policy has a direct impact on the problem. For example, it has been estimated that a one percent change in our domestic interest rate level has the impact of $3 billion on LDC debt service; a one percent change in world GNP growth has the impact of $10 billion in LDC export earnings. If we are concerned with the LDC debt problem for domestic reasons, surely these kinds of considerations should be given weight in our domestic policy formulation.

Looking ahead there is cause to be guardedly optimistic, although the margin for error is not great. Although the Group of Thirty study that I mentioned in not completed yet, my own view of the data is that while the LDC financing needs will be met in large measure by private sector financing, including commercial bank restructuring and new funding, as well as the alternative sources of finance I mentioned, official sources will have to play a major role. The IMF has been crucial in the early stages of the adjustment process, and will continue to play an essential role. The World Bank, the IFC, and the regional development banks will take on even greater responsibilities for longer term development objectives to sustain recovery and growth. From the point of view of the U.S., I think that these institutions have served our interests very well, and in a cost- effective way. As the controlling shareholder in these institutions, the United States is able to exert substantial leverage based on our relatively small shareholding. For example, within the IMF, our shareholding is 19 percent, with a leverage of approximately 5:1. In addition, the IMF itself exerts considerable leverage acting as a catalyst, with a relatively small amount of IMF funds as the core for a much larger financing package from other sources, as we have seen in the case of Mexico. In many respects our subscription to the IMF has been a very wise investment for the U.S. taxpayer. The same can be said for the other Bretton Woods institutions.

Unfortunately, the importance of their role, and their value to the United States, has been clouded by debate in some quarters that is often ill-informed. As you may recall, the issue arose at the

time of the IMF replenishment leglislation two years ago. The legislation was enacted, but not without some harm done to the image of the Bretton Woods institutions in the public mind.
At that time, as Chairman of the International Economic Development Task Force of the United States Chamber of Commerce, I testified on behalf of the Chamber in support of the IMF, and last year I testified again on behalf of the Chamber in support of the World Bank request for the IDA replenishment. As you know, the Chamber is the largest federation of business and professional organizations in the country, and is the principle spokesmen for the American business community. Without getting into all of the issues involved at this point, I should note that the Chamber has been fully supportive of those bills because the Chamber believes that they were in the best interests of the United States business community.

This is not to say that the institutions could not be improved in their operations. For example, the Chamber is now studying ways in which U.S. businessmen could take better advantage of business opportunities that arise in connection with the operations of these institutions abroad. In this connection, it seems to me that the United States Executive Director on these institutions should be given a mandate to focus on ways in which this could better be achieved. But apart from these kinds of operational questions, the value of these institutions, in terms of their basic concept and mission, must not be underestimated.

In general, they provide the United States with a tested and effective vehicle to deal with global economic problems that require international coordination and cooperation for their resolution. Specifically, they are the best chance we have, I believe, for coping with the complex problems immediately facing us in connection with the LDC debt question. More imagination and innovation in their roles will be necessary, and in my judgment more cooperation and participation with the private sector would be desirable. But the institutions themselves will need strengthening, not weakening, in order to fulfill these objectives.

I would add that our own United States agencies involved in international financing should also be strengthened at this time. It is ironic, for example, that the Eximbank is being subject to constraints just at a time in our history when the encouragement of United States exports is such an important policy objective.

In this connection, I would like to mention one other issue that has arisen recently, and that is the question of the emphasis that should be placed on bilateral financing through official U.S. agencies versus multilateral financing through the Bretton Woods institutions. I think that each has its place in our international economic policy, and each can serve a valuable function. But in view of the dominant position of influence the United States has in the multilateral agencies, the fact that we can leverage our financial contributions so effectively through those institutions, and in view of the effective vehicles they provide for coordination in the international economic sphere, it would be a mistake to think of bilateral financing as a substitute for support for the multilateral institutions.

In conclusion, Mr. Chairman, I would reiterate the thought that we should work for better coordination between our international and domestic economic policies, and closer coordination on those policies with our friends and allies abroad, in order to be more effective in furthering our own national interests in today's interdependent world.

The CHAIRMAN. Thank you very much, Mr. Debs.

Mr. Vojta.

STATEMENT OF GEORGE J. VOJTA, EXECUTIVE VICE PRESIDENT, BANKERS TRUST CO., NEW YORK, NY

Mr. VOJTA. Thank you, Mr. Chairman.

I would like to take this opportunity to emphasize one or two points which are contained in my testimony as submitted to the committee. I think we are acutely aware of the fact that the decade from 1974 to 1984 was one which could be characterized as a process of crisis, which in the final analysis put the prospects for world development at considerable risk.

Although we have continued to see the world integrate, particularly financially, one has to see that such recent phenomena as the increase in protectionism, the leveling off of the growth in volume and value of world trade, the diminution in foreign investment flows and as a consequence of the international debt crisis, the cessation of voluntary international lending by the commercial banking system, and finally the pattern of perverse capital flows, which has created an enormous capital inflow to the United States—as representing a considerable erosion in the psychology which supports ongoing economic interdependence in the world.

I urge this committee not to underestimate this change in psychology. I am sure you are familiar with the imagery that surrounds the United States as the safe haven, the last bastion, so to speak, and the place to which critical assets, particularly capital and brain power, must go.

This image relates not only to the economics of relative interest and exchange rates, but to this changing psychology, which has become negatively disposed to international investment and business commitments.

Regrettably, we have also seen that in many countries abroad during this period, a significant erosion in the incentive climate for economic development has occurred.

Mr. Volcker alluded to the issues of structural economic rigidities in Europe, which have slowed the process of growth and recovery. In many of the developing countries a similar pattern of erosion in the climate for growth and business expansion has been noticeable over the last 10 years.

In my opinion, we have tended to pay less than the necessary amount of attention to these issues relating to the local climate for development. The debate on development has tended to characterize local problems as being related to external factors—deterioration in terms of trade, and so on.

From the developing countries' perspective, we have also seen a concentration in their thought on the policies of the developed countries with a deemphasis on the problems of eroding business and investment incentives in their own particular countries.

Our progress of general adjustment has reached the point at which it can be said fairly that the developed countries have taken sufficient requisite steps to cause the world's growth trajectory to be resumed. Growth is occurring in the OECD countries and particularly in the United States.

There is an impressive movement toward stabilizing general economic and political conditions. Further progress now depends upon the host countries abroad. They possess the key to continuation in the process of economic growth worldwide; they are the key to whether or not the progress that has been made to date becomes extended and maintained.

We sometimes forget that we know the models for countries which have successfully developed. To restate the obvious, development occurs in any country when a class of that society, usually or importantly entrepreneurs captures and mobilizes a significant amount of internally and externally generated savings.

They invest these savings in productive investments. They are able to retain the profit from most of these investments and reinvest these profits in further productive investments. Meaningful development occurs when this process comes to dominate economic activity. The process is aided by free market conditions and by stable tax and judicial systems which permit stable rules of the game.

As wealth grows in a society, it is possible for the general population to participate meaningfully in the prosperity that is being created. There are many flaws in this development model that are cited. It is said to be inequitable and exploitive, fraught with risk, and uneven in its consequences. But the fact is that if one looks at our own history and development experience around the world, it is the model for development that can be said to have worked best.

I think the problem that we have now is that conditions for a resumption of development at the local level around the world have deteriorated in far too many countries. This leads to a final comment about the international debt.

The key to the debt situation over the long term is the resumption of orderly global development and the maintenance of development in debtor countries. Growth in debtor countries must be sufficient to restore servicing of external debt in terms of interest and principal. Any other solution short of that will not meet the requirements of the moment.

I would urge the committee to focus in their deliberations about our position in the world on the conditions in host countries. This is the critical factor in terms of whether or not the process of global growth can be maintained on a long-term basis.

Thank you.

[Mr. Vojta's prepared statement follows:]

STATEMENT OF

GEORGE J. VOJTA, EXECUTIVE VICE PRESIDENT

BANKERS TRUST COMPANY

Before The

SENATE FOREIGN RELATIONS COMMITTEE

February 27, 1985

PROSPECTS FOR GLOBAL DEVELOPMENT

The decade from 1974-1984 will be seen retrospectively as a period during which the progress of global development - from 1945 to 1973 - was arrested and then put at risk. Consequent to the two periods of oil shock, a pattern of global crisis emerged culminating in the world-wide recession of 1981-83, from which the global community is emerging. Led by the resumption of growth in the economy of the United States, 1984 proved to be the year during which the world community began to look forward - uneasily and tentatively - to regaining momentum in global development.

The costs of arrested development in the past ten years have been enormous; more seriously, the climate for global development has deteriorated - in some areas of the world to an alarming degree. An effective global development process requires maintenance of three basic conditions - sustained progress in exploiting the international comparative advantage intrinsic to all national economies which promotes and extends economic and financial interdependence and a growing world market; maintenance of strong incentives for development in participating countries in the global system, and finally generally stable political and financial conditions. In the watershed period of 1974-84, none of these essential conditions were sustained. Even though an overwhelming destabilizing crisis was avoided, there is no evidence that sustaining conditions for world development have been recreated as yet. It is for this reason that there is a sense of unease in the world about the prospects.

TURBULENCE AND ARRESTED DEVELOPMENT

The two oil shocks and resulting recessions were unquestionnably the trigger events for the period of arrested development. But as the decade of adversity progressed secondary and tertiary effects cumulatively affected the climate for growth adversely.

As general economic conditions deteriorated, the momentum toward greater economic interdependence slowed and even reversed.

The increase in protectionism, the leveling off of the growth in volume and value of world trade, a diminution in cross-border investment flows, and finally the international debt crisis which resulted in the cessation of "voluntary" cross-border lending by the international commercial banks, created an adverse psychology toward international business; most enterprises competing in the global market place took action designed to reduce or eliminate international risk exposures.

The most telling confirmation of this erosion of the commitment to economic and financial interdependence has been the 50% increase in the relative value of the U. S. dollar among the world currencies and the emergence of the United States as a major net importer of financial and human capital. The United States has become the "safe-haven" for the world's critical assets, capital and brainpower. The imagery of "the last bastion" and "fortress America" is strong and influential in the world today. Presently, there is no sign of a turnaround in this psychology.

Reinforcing the trend away from interdepencence, is the deterioration of the incentive climate for development in many countries, particularly in the Third World. Of all of the factors related to national economic development,incentive conditions in host countries are most important. This issue has tended to be given less than the proper degree of emphasis. Managing the incentive system for national development is the responsibility of host countries themselves. In recent years, the development debate has been skewed to attributing primary responsibility for poor performance in development in the developing countries to "external" factors or to the policies of the developed countries. Although there is some basis in in truth for this view, the governing reality is that responsibility for national development lies with the authorities in each country. It is tragic that in far too many countries, development has been arrested because of political instability and poor economic policies

By and large the major developed countries now have taken appropriate macro-level policy steps to re-establish growth in their economies at low levels of inflation. Although large fiscal deficits remain, monetary and exchange rate policies have been successfully utilized to reduce inflation, and after a period of recession to bring growth and employment rates back to improving levels. Although protectionism has advanced during this period, LDC exports to developed countries now are rising. Although there are policy flaws in the developed countries, relatively enough has been done to provide a beginning base for the resumption of global growth.

The critical question now has become whether or not the developing countries can get their own houses in order sufficiently to restore lender and domestic and international investor confidence in their economies. This is necessary to reverse the "fortress America" psychology that is operative today. It is not an overstatement to assert that the developing countries now hold the key to resumption of world development.

The establishment and continuance of sound developmental policies leading to the restoration of lender and investor confidence, would result in more stable political conditions in the developing countries. Maintenance of strategic military parity with the Soviet Union by the United States will serve to continue general stability in the great power confrontation. Given such a climate, there can be realistic hope for a period of global development on a soundly constructed basis.

At the present time, the policy dilemna for the United States is that to promote the general welfare the direction of foreign economic policy should be outward - to advance further the pursuit of global comparative advantage and extend the degree of economic and financial interdependence; this also is the key to further prosperity for the nation's agricultural, industrial, and service businesses - to compete successfully in an expanding world market. But to reaffirm this policy now is somewhat hazardous, because of the deteriorating climate for development in many countries abroad. It is the absence of hospitable "local conditions" in overseas markets which is holding back progress and giving the agents of growth pause.

THE SOCIO-POLITICS OF GROWTH

Any country which has succeeded in developing its economy to high levels of prosperity - a prosperity which, over time, has been shared by the general population - has done so by creating an effective socio-political coalition which has been committed to development and which has held power for a period of roughly 25 to 30 years. The United States achieved this in the post Civil War period; Japan and some developing countries (Singapore, Taiwan, Malaysia, for example) and Europe achieved this from 1945-73.

Development is a relatively simple process; it requires that an investing class (entrepreneurs usually) mobilize and capture a significant amount of internally and externally generated savings, invest these savings in productive enterprises, retain a substantial portion of the profit created; and reinvest a substantial portion of these profits in additional productive investments; meaningful development occurs when such a process substantially governs economic activity in a particular country over a protracted period of time. This process must be supported by the governing political coalition, and it must be guided by essentially free markets; the tax and judicial system must be such that powerful incentives and fair rules of the game are maintained in the economic system. Continuity of governance and stable fiscal and monetary policies are essential support mechanisms. As wealth grows in the aggregate through this process, the general level of prosperity rises; there does occur uneven income distribution patterns while the investing class reinvests profits to maximize aggregate growth; but over time the general population participates more fully in the aggregate prosperity that is created.

There are many flaws in this model for development, It is said to be inequitable, and exploitive; it is fraught with risk. And yet in the final analysis it is the only model that has worked; it is the generational price a country must pay to escape from poverty - once and for all. Aggregate growth must precede equity in income distribution; lack of aggregate growth results in the ultimate inequity and the ultimate tragedy - permanent poverty for everybody in the society. Development does not depend on an endowment of resources; it can be achieved by any country which is willing and able to pay the "generational price" of managing the process - in these terms.

The tragedy of the 1974-84 period is that far too many countries departed from their development trajectory; in many, the socio-political developmental coalition disappeared and has yet to reappear. Hostile political ideologies - with the flawed promise of immediate egalitarianism; a resurgence of religious fundamentalism hostile to this process; flawed and/or corrupt leadership; statist intervention and the destruction of free markets-the reasons vary considerably, but sadly whatever the reason, the result has been lost time and lost opportunities for this generation in countries all over the world.

A re-establishment of workable developmental policies is the overriding priority of the moment in nearly every country on the globe. Many countries are striving to adjust and pay the painful price of past policy mistakes. The current "austerity programs" are witness to that endeavor. As painful as these programs are, there is no doubt that to delay the process of adjustment simply prolongs the suffering and raises the price that the people ultimately must pay.

LDC DEBT IN THE CONTEXT OF WORLD DEVELOPMENT

All developing countries must service a level of external indebtedness that in the current circumstances of arrested world development has been the cause of major concern. There is no miraculous curative for the indebtedness of the developing world. The debt may be rescheduled to a prudent degree, but the fundamental reality is that the debt must continue to be recognized and to be serviced; if the debt is abrogated or written off, the global economic and financial system will be destroyed, condemning all nations to a prolonged period of depression - a new dark age.

There is only one path to the orderly restoration of debt quality and debt servicing and that is the achievement of renewed development in the developed countries and in the Third World. The Third World must grow out of its debt burden and it will do so to the degree that it re-commits itself to the proven process of development. Each country, by itself, must make its own sovereign decision to re-commit its policy priorities to development. Those that do not condemn themselves to poverty; those that delay are but losing precious time and increasing the costs of adjustment; those that have done so are already seeing visible signs of recovery.

If a meaningful level of development can be sustained, confidence will return and resources will be available to the developing countries in the interest of their development. The debt problem is this simple - and this difficult.

POLICY OPTIONS FOR THE UNITED STATES

The long-term interests of the United States require that it strongly encourage the adoption of appropriate developmental policies in the world community. Our government must be candid and forthright in foreign economic relations to this end. Those countries which move on the right policy path - represent our long-term markets; our best opportunities for investment, and appropriate sources of essential resources and competitive imports. Our domestic economy must be "open" to these countries to give them maximum opportunity to succeed. An effective IMF, the only institution which can monitor policy trends in member countries, is indispensible to our interests - it deserves maximum support and encouragement.

Looking ahead, one can see a major structural transformation of the world economy. The developed economies are phasing out of basic production and moving strongly toward technologically driven, higher value production on the farm and in industry, and toward the development of service industries. All segments of our economy need the scope of the world market to generate maximum employment for our people. Participating in the restructuring of the world economy is a major opportunity for the developing countries - representing important potential for positive growth in income and employment. If their developmental policies are correct, they can participate gainfully in this adjustment process.

There is hope; a solid basis for optimism; we know what to do and how to do it - and much has been done, already. As always the question will be - does the global society have the will to finish the business at hand.

Senator **Mathias** [presiding]. Thank you very much.
Mr. Tanselle.

STATEMENT OF DONALD W. TANSELLE, VICE CHAIRMAN, MERCHANTS NATIONAL BANK & TRUST CO. OF INDIANAPOLIS, INDIANAPOLIS, IN

Mr. **Tanselle**. Thank you, Senator.

I will address myself to the regional banks' perspective on the role America should play in the global economy and what the United States can do to stimulate world economic growth. I can summarize my suggestion with one word: "stability."

As the world economies begin to shake off global recession, it is common to hear the U.S. economy described as pulling the other countries along. When the U.S. domestic economy begins growing, consumers have more money to buy imports and business has more need to import raw materials, components, and finished goods. Given the stimulus of supplying that additional demand, the economies of other countries begin their expansion.

On the other hand, an economy not only accelerates, but also slows down. When the U.S. economy slows, imports are reduced and foreign economies feel the effects.

In the high inflationary period of the seventies, commodity prices, including oil, were at all-time highs and rising. Shortages of raw materials, even their exhaustion, were predicted. Widespread world starvation was forecast. Where are we today? Commodity prices are low and barely rising, despite a strong economic recovery. Those predicted shortages have not occurred. Food shortages are not a problem of production, only of distribution.

What caused so many to be so wrong about so much? They failed to recognize what economic history has taught about economic distortions, and that is that over time natural market forces have an unfailing ability to correct imbalances. When the pendulum drifts to one side, natural forces bring it back.

But if that pendulum were forced back by external forces, it may swing too far. Today we see copper mines closed in the United States and developing countries struggling with the low price. We see the British pound falling to historical lows, though it may have recovered a bit, partly due to reduced oil prices. And we see farmers losing their land.

The problem with economic distortions is not that they will not be corrected over time. They will. The problem is the pain and suffering in the meantime and the risk that today's solution may cause tomorrow's problems.

During the high inflationary period in the seventies, real interest rates in the United States were negative. A good investment, it was said, was debt. Those who did take on long-term debt, from American farmers to Latin American countries, face years of painful readjustment now that we have high positive real interest rates today.

America's role in the global economy should be one of a stabilizer. Its actions can help the world prosper or cause widespread distortions.

I would be remiss if I did not mention the difficult time Indiana business is having with the strong dollar and Latin American debt problems. I would like to give some examples. A manufacturer of pump irrigation and drilling equipment was exporting over 50 percent of its output in 1981. Nearly two-thirds of that export capacity has been lost in 1984, and that has resulted in a loss of 20 jobs.

In 1984, a large Indiana supplier to manufacturers of construction equipment experienced a decline of 70 percent from 1981 export levels to Latin America. Reductions for the rest of the world are smaller than 25 percent. The job loss here was 200 jobs.

A company in the chemical business advises us that profits have been so negatively impacted by reductions in foreign sales that expansion plans have been shelved. Besides the direct loss of jobs within the company, employment in the construction industry was also lost.

The hardwood and veneer industry has had a long history in Indiana. One supplier of machinery in that industry saw its exports of $1.1 million in 1982 drop to $150,000 in 1984. More importantly, that supplier is aware of over 25 domestic veneer mills which have stopped exporting because of uncompetitive prices, despite access to the world's best hardwood and use of the most efficient machinery.

Another strength in Indiana is electronics. Given the high-tech nature of this industry, it has not suffered to the extent of many others. Nevertheless, one electronics firm advises us that in 1984 export sales to Latin America are 25 percent below its 1982 levels, and sales in 1985 are expected to be lower.

Latin America has had to reduce its imports in order to conserve precious foreign exchange and to repay debt. Through this process, U.S. exports to Latin America declined 31 percent or $12 billion in 1984 compared with 1981. We are told that this represents 300,000 fewer jobs, which is the price we pay for those debts.

Typical of many regional banks, our international financing focuses on the trade needs of our local business community. For us, the large Indiana export market has been an attractive source of business.

As the ninth largest exporting State in the Union, Indiana has suffered from the strong dollar and from import reductions by Latin American countries. Given time, these two economic abnormalities will adjust themselves. The goal of Government, however, is to reduce the hardships in the meantime.

As you might imagine, I do not suggest trade protectionism as a course of action. Rather, the goal should be to bring down the dollar at a steady pace, and interest rate reductions appear to be the only effective tool in the Government's hands.

Although the strong dollar would eventually succumb to the trade deficit, it is within the Government's ability to bring it about sooner. Foreign policy of the United States cannot ignore the effect it has on trading partners around the world. Our good fortune at the expense of another economy finally brings detrimental effects to our shores. Any support to this end is not aid but an investment to assure stability of the economies on a worldwide scale and consequently at home.

Thank you.

[Mr. Tanselle's prepared statement follows:]

STATEMENT OF

DONALD W. TANSELLE

VICE CHAIRMAN

MERCHANTS NATIONAL BANK AND TRUST COMPANY

OF INDIANAPOLIS

BEFORE THE

SENATE FOREIGN RELATIONS COMMITTEE

WASHINGTON, D.C.

FEBRUARY 27, 1985

Mr. Chairman and Members of the Committee:

I am Donald W. Tanselle, Vice Chairman of Merchants National Bank & Trust Company of Indianapolis, the third largest bank in Indiana. With $2.3 billion in assets Merchants is a medium-sized regional bank and is, I believe, representative of many regional banks in the focus of its international banking business on trade financing.

I will speak to a regional bank's perspective on the role America should play in the global economy and what the United States can do to stimulate world economic growth. I can summarize my suggestion with one word: stability.

America's Strength in the World Economy

As the world's economies begin to shake off global recession, it is common to hear the U.S. economy described as pulling the other countries along. When the U.S. domestic economy begins growing, consumers have more money to buy imports and business has more need to import raw materials, components and finished goods. Given the stimulus of supplying that additional demand, economies of other countries begin their expansion.

On the other hand, an economy not only accelerates, but also slows down. When the U.S. economy slows, imports are reduced, and foreign economies feel the effects.

In the last fifteen years the U.S. economy has been unpredictable and disruptive. Wide swings in interest rates, GNP, foreign trade, and exchange rates, have disrupted, not only our own well-being, but that of much of the rest of the world as well.

In the high inflationary period of the Seventies, commodity prices, including oil, were at all time highs and rising. Shortages of raw materials, even their exhaustion, were predicted. Widespread world starvation was forecast.

Where are we today? Commodity prices are low and barely rising despite a strong economic recovery. Those predicted shortages have not occurred. Food shortages are not a problem of production, only of distribution.

What caused so many to be so wrong about so much? They failed to recognize what economic history has taught about economic distortions. That is, over time, natural market forces have an unfailing ability to correct imbalances.

Those high prices and shortages were an aberration not the norm. High copper prices caused more mines to come on stream; cartel-supported oil price levels enticed exploration and conservation; and unusually high food prices brought more land into cultivation.

When a pendulum drifts to one side, natural forces bring it back, but if the pendulum were pushed back by external forces, it may swing too far. Today we see copper mines closed in the U.S., and developing countries struggling with the low price; we see the British pound falling to historical lows due partly to reduced oil prices; and we see farmers losing their land.

The problem with economic distortions is not that they will not be corrected; over time, they will. The problem is the pain and suffering caused in the meantime, and the risk that today's solution may cause tomorrow's problem.

During the high inflationary period in the Seventies, real interest rates in the United States were negative. A good investment, it was said, was debt. Those who did take on long-term debt - from American farmers to Latin American countries - face years of painful readjustment now that we have high positive real interest rates today.

Often these parties were encouraged to assume this debt by well intentioned government policies. When we bankers made those loans, we note that we also fell into the trap of expecting the unusual to be normal.

America's role in the global economy should be one of a stabilizer. Its actions can help the world prosper or cause widespread disruptions.

A decision made on the assumption that the United States has a totally insular economy may grant temporary relief to a domestic problem only to cause a larger problem later. The humanitarian issues aside, for its own self-interest, the United States must consider its economic actions with a broad, forward looking perspective.

The Dollar, Latin American Debts, and the Trade Deficit

I would be remiss if I did not mention the difficult time Indiana business is having with the strong dollar and with Latin American debt problems.

A manufacturer of pump, irrigation and drilling equipment was exporting over 50% of its output in 1981. Nearly two-thirds of that has been lost by 1984. Export sales to Latin America have dropped to almost nothing in that period. The company estimates unemployment losses at 20 people.

In 1984 a large Indiana supplier to manufacturers of construction equipment experienced a decline of 70% from 1981 in exports to Latin America. Reductions for the rest of the world are a smaller 25%. The job loss is estimated at 200. The company is concerned even more about 1985 because many of 1984 exports were sold under long term contracts which will not be renewed under the current exchange rate differentials.

A company in the chemical business advises us that profits have been so negatively impacted by reductions in foreign sales that an expansion plan has been shelved. Besides the direct loss of jobs within the company, employment in the construction industry was also lost.

A small manufacturer of food packaging equipment saw its 1982 export sales of about $1 million drop to almost zero in 1984. The company notes that its major export market, Latin America, has dried up completely, and only sales of replacement parts were made to the rest of the world. As many as twelve employees may have been affected.

The hardwood and veneer industry has had a long history in Indiana. One supplier of machinery to this industry saw its exports of $1.1 million in 1982 drop to $150 thousand in 1984. More importantly, the supplier is aware of over 25 domestic veneer mills which have stopped exporting because of uncompetitive prices, despite access to the world's best hardwood and use of the most efficient machinery.

Another Indiana strength is electronics. Given the high tech nature of this industry, it has not suffered to the extent of many others. Nevertheless, one large electronics company advises that its 1984 export sales to Latin America are 25% below its 1982 level. Sales in 1985 are expected to be no better.

I alluded earlier to the debt problems of Latin America. The remarkable progress displayed by some Latin American countries clearly marks the trail for the others. Their success has come about through an accommodating U.S. economy, which has taken the brunt of Latin America's retrenchment.

In 1984 Latin America exported about $50 billion to the U.S., about $11 billion more than in 1981. At the same time their exports to the rest of the world were down about $10 billion. If the rest of the world were as accommodating in accepting their exports as the United States, Latin America would be well on its way to economic health. Although it is essential that we keep our markets open to their products - except dumping, of course - the United States should also encourage other major countries to avoid artificial restraints on Latin American exports.

Latin America has had to reduce imports in order to conserve precious foreign exchange to repay debts. Through this process U.S. exports to Latin America declined 31% ($12 billion) in 1984, compared with 1981. This represents about 300,000 fewer jobs, the price *we* pay for those debts.

Conclusion

Typical of many regional banks, our international financing focuses on the trade needs of our local business community. For us the large Indiana export market has been an attractive source of business. As the ninth largest exporting state, Indiana has suffered from the strong dollar and from import reduction by Latin American countries.

Given time, these two economic abnormalities will adjust themselves. The goal of government, however, is to reduce the hardship in the meantime. As you might imagine, I do not suggest trade protectionism as a course of action. Rather, the goal should be to bring down the dollar at a steady pace, and interest rate reductions appear to be the only effective tool in the government's hands. Although the strong dollar would eventually succumb to the trade deficit, it is within the government's ability to bring it about sooner.

Support for multinational agencies such as the International Monetary Fund is crucial in the readjustment process for Latin America. The funds to support the IMF are small, compared to the price we paid in unemployment from lost export sales. The sooner we help Latin America back on its feet, the better off we will be. The most effective medicine is continued support for such agencies.

Foreign policy of the United States cannot ignore the effect it has on trading partners around the world. Our good fortune at the expense of another economy finally brings detrimental effects to our shores. Any support to this end is not aid but an investment to insure stability of economies on a world-wide scale and consequently at home.

The **Chairman** [presiding]. Thank you very much, Mr. Tanselle.

Senator Mathias, do you have time constraints? If so, I will yield to you for your questions first.

Senator **Mathias**. Well, I was interested in something. Mr. Tanselle gave us a one-word prescription for something, which was stability. Mr. Vojta gave us a one-word prescription, although he did not express it in one word, but it was growth, I believe.

Are you talking the same thing?

Mr. **Vojta**. How about stable growth?

Mr. **Tanselle**. I would subscribe to that.

Senator **Mathias**. The other thing in Mr. Tanselle's statement that intrigued me is, he said it was within the ability of Government to address the hard dollar question which was creating the trade deficit.

Mr. **Tanselle**. Yes, sir.

Senator **Mathias**. That is a question that we will be addressing here in Washington in the days immediately ahead. I am not sure we have the answer to it yet.

Mr. **Tanselle**. But you have the ability over time, sir, and we support you on it.

Senator **Mathias**. I hope you are right. Thank you very much.

The **Chairman**. Let me just follow through with Senator Mathias's question about Mr. Tanselle's statement that it is within the Government's ability to bring it about sooner, namely, the dollar's strength and its decline.

Each of you gentlemen may have some ideas about actions that Government could take in this regard. Would each of you comment on appropriate action as you see it that the Federal Government or the Federal Reserve Board or any agencies ought to take? Mr. Tanselle, first of all, do you have any prescription for governmental action?

Mr. **Tanselle**. I think from the perspective of a regional bank and from the perspective of the State of Indiana and the effect of the trade deficits and the high dollar on our economy, Mr. Chairman, we would urge that the Foreign Relations Committee and the Congress and the administration not abandon the aid that they can give through the IMF and other agencies to our trading partners. Keep in mind that as we aid their economies, it will eventually come back to our own, and only by making those economies strong I think, as one of the gentlemen here commented, the wage rates in Mexico, because of some of the strong steps that were taken there and imposed by the U.S. Government have reduced by 30 percent. At some point we cannot allow that to happen. At some point their problems become ours.

The **Chairman**. Mr. Debs, do you have a comment on appropriate governmental action with regard to the dollar coming down in relation to other currencies?

Mr. **Debs**. I think my first comment, which does not get us far, is that the U.S. Government should focus on that as a policy objective, and I do not think that we have. We have to use the basic tools, I think. They are going to be much more productive in the long run, and I think of monetary policy and fiscal policy.

I would endorse what Chairman Volcker said about the budget deficit. I would also endorse the idea that you cannot stretch monetary policy if there are other considerations, for example, to bring interest rates down, which to my mind would clearly have a beneficial impact on the dollar rate.

It would also have a beneficial impact on our LDC partners. It would have the same kind of impact on our OECD partners, permitting them to stimulate growth. Lower interest rates in the United States would clearly be a good thing for everybody concerned, but I would not do it at the price of pumping up inflation again.

However, I do not believe that even in monetary policy within the Federal Reserve, which I think has been the most sensitive to these international implications, I do not think that enough weight has been given to this international dimension, and Chairman Volcker said today that is a question for debate, how much weight do you give.

In my opinion, we have not given enough to that international impact of our high interest rate regime, whatever the beneficial effects are on our domestic economy, but again, I get back to the argument that what we are doing on the international side affects our domestic economy directly, and so you cannot simply say that this is an international ramification and this is domestic.

Therefore I think the Fed should give more weight to it. I certainly think on the side of fiscal policy much more weight should be given to that implication. The deficit is affecting our domestic economy because it has an impact on the international side, on the dollar exchange rate.

I mean, you can debate the links, but in that particular respect on fiscal policy I certainly think some kind of mechanism should focus on those international implications of fiscal policy.

I will make a recommendation for want of thinking of anything else to do that perhaps we should think of some kind of reorganization, some high policy committee in the White House perhaps that would focus on this particular aspect.

I might say also, Senator, that the first thing that comes to mind as a tool is intervention. I think it does have a very important role to play, but it is just a tool. It is a peripheral tool which can be used very effectively, but it is the basic policies that have to be looked at.

On that particular point, I do not think we have used our intervention capabilities effectively. We have not coordinated as well as we should with our allies, and I think there is room there to develop that much more than we have.

The CHAIRMAN. Thank you.

Mr. Vojta.

Mr. VOJTA. I would second the comments that have been made. The policy focus with regard to the dollar, must remain on the root causes of the problem, and on the domestic side of things, I think that is attention to the deficit.

In the international marketplace, it is a question of two things, opening up further the international trading system, removing some of the blockages that have been built up over the last 10 years, and pressing forward with growth-oriented policies in the economics of our trading and financial partners around the world.

That is the sound long-term approach to this issue; it would create the best conditions for a reequilibrating, readjustment in the value of the dollar.

I tend to be very cautious in giving any long-term value to inflating, to using monetary policy or intervention policy to produce the desired result, because I agree with Chairman Volcker that these will tend to be counterproductive in the absence of significant actions on these taproot types of problems.

The CHAIRMAN. Just as a technical matter, each of you gentlemen will probably have some expertise in this area, in intervention attempts. Is it possible to change the dollar strength significantly, given the strength of the flow apparently against you?

In other words, the magnitude of the change of the dollar has been such that it is awesome to think of how many dollars, francs, marks, whatever, might have been expended in the midst of this avalanche. Are we still dealing with that kind of phenomenon, or do you feel that we are at the margin in which the momentum of the change is slowing down? There is no appearance of that thus far, but it might slow down. Do you intervene at that point or at the crest? Given this trend, what does intervention mean?

Mr. VOJTA. I think you are correct, Senator; intervention opposite the major flows in the market simply in our experience has proven to be fruitless. One can make the case that intervention has been of use in short periods to stabilize market conditions, to prevent chaotic conditions from establishing themselves, but to try to buck a fundamental trend, the experience has been that massive resources have simply been squandered, and in a short period of time the trend that was asserting itself ultimately prevails.

In terms of where we are today, these are judgment calls really, but one has the sense that perhaps the strength of the dollar is reaching its peak. It has strengthened considerably far, and markets tend to readjust. My intuition is that we are somewhere close to that area at this point.

Mr. DEBS. If I may, Senator, I think that it can be useful as a tool to supplement a basic policy posture, and if the market, for example, were convinced that we wanted to go in a certain direction, that we had certain policy objectives, and considered that as a long-range objective or a medium-range objective, I think that at the right times intervention in coordination with other central banks and in size enough to impact on the market can be very useful. I mean, it is a statement. it is a fact; it is an action; it is not just words that indeed there is a certain direction that the countries involved would like to see the rates go.

As Chairman Volcker said, you cannot write a rulebook on it; it has been tried. I was at the Fed myself many years ago when that exericse had gone on, and it is fruitless, but it is something that can be effective at the right time.

The trick is picking the right time, and the market reacts to that. The foreign exchange market is very sensitive, as you know. Just look at the last few weeks. A sentence here, a sentence there by the President and Chairman Volcker has an impact.

That action of intervention can have an impact, can contribute, not change a basic trend, though. But the market has to be convinced that that basic change in trend may be a policy of the countries concerned.

Mr. Tanselle. Senator, I would come back to my one-word solution, which is oversimplifying, I agree, and that is stability. To the extent that we can encourage global stability politically and economically, we will begin to address the inflows and begin to balance the flows of currencies around the world.

To the extent that we do not make the sacrifices that are necessary, and there will be sacrifices to accomplish this, we will not correct those imbalances, and as long as they are not corrected, then there will be the problem to some degree always existing.

I would urge the committee not to look for quick fixes, but to look for permanent fixes.

The Chairman. Let me ask you this question. In terms of the basic flows, quite apart from policies that we might adopt, I would be in agreement with you that the budget deficit problem we are tackling—I am advised this afternoon we will have an opportunity to tackle it on two farm credit amendments, for example, and we may or may not be successful in tackling it on those, but to the extent that we are able to do that, everyone agrees that this is in the best interest of our country and the world.

In your testimony, you have raised two factors that lead me to wonder if they do not surmount all of our domestic politics. Mr. Vojta emphasized the problem of safety and assurance that we may have all underestimated the degree to which foreign investors, money people want to make certain that their capital remains intact. There may be a point that they are willing to accept a substantially lower interest rate, in fact, maybe no interest rate at all if it is a question of retaining the capital that is involved.

Mr. Tanselle has talked about stability, and clearly there could be a great deal of this without that changing the psychology of the cautious foreign investor, who just says we are going to continue with tensions in a world involving the superpowers, and we are going to have apparently continual difficulties in the Middle East and Africa and Central America, and all things considered, it is best to keep flowing this way.

Now, this in combination with the point that all of you made one way or another that in all of the IMF dealings and in our own banking strictures we have become more cautious in lending money to other nations, so the recycling of petrodollars and other international exchanges that accompanied another era certainly are not a part of this one.

Most prudent bankers either at the international level or the national level or the regional level have been more cautious. In fact, some have to be coaxed awfully hard to even participate in a small flow to keep things going.

Now, what in the intermediate future is likely to change either of those two trends, both of which tend to strengthen the dollar in relationship to other currencies. Is it not possible we will have some success maybe, we will get the $50 billion of reduction that Chairman Volcker said would be significant to the markets, and I think that is conceivable, and still come to the end of that road toward the end of the year and find that the flows that we are describing continue, and the dollar remains much stronger than any of us would have predicted, thus leaving all of the import-export problems that Mr. Tanselle described so poignantly in a State that I serve.

Can any of you address the general picture of these basic problems?

Mr. **Vojta**. I believe this is a very important question, because the issue is that in too many countries abroad, to summarize it in one sentence, there is an absence of lender or investor confidence in the country, investors being both domestic investors, local citizens, and foreign investors.

One can imagine that one possible course of events would be that in the United States we take some significant action on the deficit and manage our own situation as well as we can and maintain a steady growth path and so on, and yet if that psychology in local economies is not restored to a positive state of affairs, nothing would happen with regard to these fundamentals in any meaningful sense.

It is for this reason that I have chosen to emphasize to you that in our economic relations with our friends and allies a part of our orientation must be to stress the importance of restoring the developmental orientation of their economies, their politics, their societies, and the importance of continuity of these policies over a long period of time.

And that is fundamentally a matter for their own sovereign judgment, which is why the issue produces a sense of relative helplessness on our part, but we can make our views and positions known. Again, we have reached a point where locally managed growth is the key to the whole adjustment process.

The **Chairman**. In almost every democracy, not only of the Western European variety, but of the Central American or Latin American variety, there is a very strong push for more of a safety net, more social services.

If there is one general trend in each of these countries, it comes down to the need to do more for people in social services. We see one part of this in another set of our hearings in which defense expenditures are always pointed to as being excessive because the pressures of the social services continue to increase and growth has not been very great, maybe negative, so that it is devisive and becomes tougher.

Now, given that picture, it is hard to name half a dozen countries in which investors looking at it in a very hardheaded way would anticipate that their money is going to be safer, and even given all of our troubles, which are well advertised, and wrestling with our own safety net and our deficit; in almost each instance an investor would say the United States is probably a better bet if you are talking about fundamental safety.

I am just looking at the trend of affairs. I do not see anything on the horizon that would suggest in a relative way that we are going to get weaker, I mean, the question of whether we do well enough in an absolute sense, I suppose, to shore up the whole situation.

Mr. **Debs**. I would agree with that, but there is a limit to that kind of reasoning, and I could assure you that at some price that trend will change. There is no doubt that the attraction of the U.S.

economy, the U.S. political structure is a major element in the strength of the dollar and the flows coming in.

There is no doubt about it. It is very hard to measure. But at some price there are alternatives that are going to seem more attractive, and when we talk about the capital flows, most of them are coming from the OECD countries, and the other currencies we are talking about basically are the deutschmark and the yen and to a lesser extent sterling.

At some price, that security element will be traded off, at lower interest rate levels here, higher levels abroad, better stock market performance abroad, and a trend in the dollar.

If people are convinced that the dollar is going to be changing direction, that is going to be part of their return, and if they see negative return on that, lower interest rates here, better stock market performance elsewhere, or better investment opportunities, that switch will come. It is simply a question of when that line is crossed.

Mr. VOJTA. I would like to urge the committee, if you have time at some point in your deliberations, to solicit some input from various groups that influence opinion on development abroad, because I think one of the troublesome aspects of the present situation is the hostility from many intellectual and philosophical points of view that has been interjected into the policy thinking overseas about the appropriateness of development in a classical sense.

You can see it in the major religious traditions in the world where there is an orientation toward maintenance and, as you point out, social services. You can find it in some of the political thinking that is now in power, so it is not a very salable proposition in many, many countries now to say we must reestablish investment and credit incentives for development as a matter of top priority.

As Richard says, that may change, and at some point the risks and rewards may be such that a reverse flow will occur, but as long as you have this negative psychology prevailing and coming into the picture from many different sources, you are quite right, that business enterprises, investors, financial enterprises are going to be extremely cautious in their risk-taking attitudes about international business and investment.

The CHAIRMAN. As a followup to what you are saying, Mr. Vojta, we have seen even in our dialog in this country the introduction of a letter from the Catholic bishops.

That letter fairly well exemplifies the thinking of many social democrats in Europe as it stands and has a very strong humanitarian voice, but as you would point out, it is not prodynamic development or aggregation of capital. It is a question of redistribution of income essentially, a stronger safety net.

In addition to the problems of fledgling democracies and the overall demands of people, there also are the trends we have noted in a country such as Iran in which a part of the criticism of the Shah was that he wanted extravagant development. The Ayatollah Khomeini might have said that this really poisoned the will of basic Islamic thought as people took a look at it, that life is not development and Western materialism, that it has a religious content, so you then get factors that are even different from the problems of the safety net, a sort of rejection of development altogether, but it all leads back, I suppose, to the question we are addressing, and Mr. Debs has said at some point even given all of that there are tradeoffs that come.

Have any of you examined the sort of cliff-hanging situation in which even if we are relatively stronger than the rest and the flow still comes our way there would come a day if deficits became too high in the United States that we would have a Treasury bond auction, and not enough people would come to it to buy the bonds, whether they be domestic or foreign investors, even in this country, which is the most stable.

Is there ever a possibility that we are going to come to a point in the world where confidence has been diminished in other countries, though still is relatively stronger here, but even we have a problem of financing the level of public debt which buttresses all the rest of these mechanisms maybe by default of several others all around.

In your circles, does this sort of apocalyptic thought occur?

Mr. DEBS. People might show up and demand a higher price. We may have to pay 20 percent on a Treasury bill under those kind of circumstances.

The CHAIRMAN. But they would still be willing to bargain for a rate as opposed to not showing up then?

Mr. DEBS. Yes, I would think so. You would have to paint a very bleak scenario indeed to discourage someone from investing in U.S. Government credit at a good price, but clearly that is a problem.

That is another factor in the interest rate scenario itself. If this flow from Japan, where the capital flows total close to $50 billion, most of it toward the dollar, if they should have other attractive investments there, if they could mobilize their own very high savings rate domestically, you simply would not see it here. It just would not come in the kinds of magnitudes it has.

The impact of that would be higher rates here, because our Government would have to finance that deficit, and they would simply have to pay the price.

Mr. VOJTA. It is probably instructive to reflect back a little bit on the history of the New York City fiscal crisis, and if anything got to that extreme, it would probably be of a similar nature in the sense that most of the buyers of Government debt are institutional, and they monitor financial and fiscal performance quite carefully, and as we saw in the New York City crisis, a point was reached where the consensus of institutional underwriters and investors said, this has gone far enough, and until there is a fiscal stabilization program that is satisfactory, it is going to be impossible for us to underwrite, place and deal various kinds of city issues. It would probably take that form if the fiscal affairs of the United States would reach such a point of disarray that that kind of negative judgment by investors would be warranted. I do not think we are near that now, but it would be of that nature if it ever came.

Mr. TANSELLE. Senator, I would come back to a point that you raised a while ago with regard to the caution for lending and investment in foreign countries. I think it could be a mistake to try to equate that level that we are doing now or might be doing to that which was done a few years ago when some of the problems occurred.

Those loans, many of them we have to admit were not well structured, and we can go back domestically and look what happened in the seventies in the real estate industry, where there were great losses because loans were not properly structured for the type of situation that was there. We have learned a lesson from it. There are conditions being placed on lending in foreign countries now which were not there before.

The IMF restructuring, all of the restructuring are placing conditions which, even though it does bring some temporary pain to countries, is constructive to this overall matter of confidence, because it causes people to begin to live more within the levels of their abilities to repay.

The CHAIRMAN. So you are making the point that we have restructured in an international sense perhaps also that banks in this country may be stronger in terms of their balance sheets than they were a couple of years ago?

Mr. TANSELLE. I do not think there is any question but what the restructured loans are more realistic in their terms of repayment than those which were originally on the books.

The CHAIRMAN. Gentlemen, we deeply appreciate your coming here this morning. Your testimony will be an important part of our record, as well as the responses to questions. We look forward to seeing you again on other occasions. This hearing is adjourned.

[Whereupon, at 2:28 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, February 28, 1985.]

THE UNITED STATES IN A GLOBAL ECONOMY

THURSDAY, FEBRUARY 28, 1985

United States Senate,
Committee on Foreign Relations,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar (chairman of the committee) presiding.

Present: Senators Lugar, Helms, Mathias, Kassebaum, Boschwitz, Murkowski, Trible, Evans, Pell, Cranston, Dodd, and Kerry.

The Chairman. This hearing of the Senate Foreign Relations Committee is called to order.

We are delighted to have a distinguished panel before us this morning, which includes Richard Cooper, Martin Feldstein, Henry Fowler, and Robert Hormats.

Each of you has been asked to examine America's role in the global economy, focusing particular attention on how the United States best can contribute to sustaining global economic growth, and what you view as the most serious impediments to such growth at present. We look forward to hearing your views.

I should warn you at the outset that we must break briefly at about 11 o'clock to vote on the President's nominees for the three arms control negotiating positions; but we hope that will not be a great intrusion in the testimony, and that we will flow through it after that.

Let me ask Senator Pell, the distinguished ranking member of the committee for any opening comments which he may have.

Senator Pell. Thank you. I have no opening questions. I would just join with you, Mr. Chairman, in welcoming the witnesses.

The Chairman. I would like to ask Senator Mathias, who is chairman of the subcommittee that has shepherded over these issues for an opening comment.

Senator Mathias. Mr. Chairman, we have four wise men before us, and I think it would be folly for us to speak at length from this vantage point.

The Chairman. A splendid comment.

With that in mind, let me ask you to testify in this order, if you will. First, Mr. Cooper, then Mr. Feldstein, Mr. Fowler, and Mr. Hormats.

Gentlemen, if you would attempt to give your testimonies in 10 minutes or thereabouts, that would be helpful. We will not be rigorous, but we do want to hear your views, to the extent that is possible. We will then go into questions with a 10-minute limit on the first round of questions by committee members, to which each of you may respond or the questions may go to all of you in that case.

If you would then proceed, Mr. Cooper, we would appreciate your testimony.

STATEMENT OF RICHARD N. COOPER, MAURITS C. BOAS PROFESSOR OF INTERNATIONAL ECONOMICS, CENTER FOR INTERNATIONAL AFFAIRS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. COOPER. Thank you very much, Mr. Chairman. I am delighted to be here this morning on this very important topic.

We are now recovering from the worst economic downturn in 50 years. The impetus to recover is being provided by the United States, and to a lesser extent by Japan. Europe is still in what is called a growth recession, and many less developed countries are still in a period of retrenchment due to heavy debt burdens and still weak international terms of trade.

The dominant feature of the world economy today is the huge U.S. deficit in international trade in goods and services, reckoned at roughly $100 billion for last year. This is an historically unprecedented level, both in dollar terms and as a share of GNP, about 2½ percent of GNP. It is worth recalling that the last major deficit of the United States, which was the cause of so much alarm in the financial community in 1978, was $15 billion, one-seventh of the size of the current deficit and well under 1 percent of GNP.

Now, this deficit, and its rapid growth in 1983 and 1984, has a variety of effects. Other things being equal, it slows the growth of the U.S. economy and acts as a drag on U.S. recovery; but by the same token, it also helps keep inflation in check by providing a flow of imports to satisfy rising U.S. demand. Finally, and not least from the point of view of the rest of the world, it is the main mechanism by which U.S. recovery gets transmitted abroad. The rapid rise in U.S. imports has provided welcome stimulus to other industrial economies, and it provides welcome foreign exchange earnings to the debt-ridden countries of the world.

Why is the deficit so large? There are three reasons that are usually mentioned. The first has to do with the phasing of recovery. The U.S. recovery has been much more rapid, more vigorous than recovery elsewhere in the world, so that our imports rise more rapidly than our exports.

Second, many developing countries, especially those in Latin America, have tightened their economies considerably in order to cope with their own worsened balance of payments position, which in turn was due in part to a drying up of flows of capital, in part to high world interest rates, and in part to the world slump itself.

And it is worth noting that the current account position of Latin America has improved by $30 billion in the last 2 years, much of it being the obverse side of the U.S. deficit.

Finally, and not least, the U.S. dollar has been extremely strong relative to other major currencies, up nearly 40 percent in real terms since 1980.

Now, why, in turn, is the dollar so strong? Three reasons are given for this as well. First, the United States is a safe haven for capital from around the world, so funds flow in seeking political or economic security and drive up the value of the dollar.

Second, tight monetary policy and expansionary fiscal policy in the United States taken together raise U.S. interest rates and draw in capital from around the world.

And third, we are in a speculative bubble in which investors around the world are bullish on the dollar, mainly because everyone else is bullish on the dollar, and market strength feeds on market strength. Although everyone recognizes that the value of the dollar is unsustainably high in the long run, each investor-speculator feels that he can get out before the crowd does.

Now, these are three very different, although not incompatible reasons for why the dollar is strong. I am inclined to give rather little weight to the first reason. I am inclined to give the most weight to the second reason, the configuration of macroeconomic policy here and abroad. And I am inclined to give some weight, although less than to the second, to the third reason. I think we are in something of a speculative bubble in which market strength feeds on market strength.

If my judgment about the relative weights of these causes is correct, it suggests that there is an intimate, although a complex relationship between U.S. fiscal policy, the dollar exchange rate, and the U.S. trade balance.

The current configuration of policies here and in the other major countries is resulting in exceptionally severe competition for U.S. firms at home and abroad.

I am going to turn now to the trade issues. We hear a lot these days from many quarters about unfair competition from other countries, and there is no doubt that competition is very acute. In these circumstances an American business firm or labor union will look much more closely at foreign practices, and not surprisingly, they discover that foreigners do things differently from the way Americans do.

Although these different foreign practices have often been around for many years, American firms and unions are now saying we can't compete with that, and they appeal to the administration or to Congress for protection against the offending practices.

I believe that this is an understandable but myopic view of what is really going on, and indeed, it reflects a fundamental error that underlies much even informed discussion with respect to so-called unfair trade practices and other policy distortions to international trade flows. And that error is the supposition that the overall trade balance, and aligned behind that economic growth and employment, are determined or even strongly influenced by these foreign practices that limit particular imports or promote particular exports from the country in question.

Concretely, the Japanese, who are often looked to as the principal offender, could remove every policy measure and alter every practice that foreigners point to as restricting imports, and the consequences would not involve a reduction in the large Japanese trade surplus and might not even result in an overall increase in Japanese imports.

The reason is that a country's balance on trade and goods and services is determined by the difference between national savings and national investment, and it is only insofar as actions influence savings and investment that they can influence the trade balance.

This relationship is of fundamental importance in assessing overall trade performance. I am not talking now of particular industries, but overall performance. While lifting the Japanese citrus quota will almost certainly raise Japan's imports of citrus, and will probably raise overall Japanese imports but by much less than the increase in citrus imports, it would not reduce the large Japanese trade surplus except insofar as lifting the quota affecting national savings and/or investment; that is to say, probably not at all.

Given a large savings-investment imbalance, a rise in one particular import will be offset by a decline in other imports and/or a rise in exports. Paradoxically, it is even conceivable that a stripping away of all Japan's protective practices will lead to a rise in Japan's trade surplus rather than a decline, if the sudden import competition reduced Japanese investment more than it reduced savings.

The point is that to assess the overall impact, one must look beyond the commodities immediately affected by the change in policy. The significance of this in the present context is that since 1981 the United States has had a large and rapidly growing trade deficit whereas Japan and several European countries have developed large surpluses. But these external imbalances arise from overall macroeconomic developments and not from unfair trade practices, how many of those there might be.

For purposes of addressing policy, it's essential to make the distinction between the macroeconomic determinants of the overall position and the individual industry-by-industry specific foreign practices. Failure to do so is bound to lead to frustration, since even a vigorous use of the wrong instruments will not achieve the desired objective.

Now, let me put some figures on this. In 1984 the United States ran a current account deficit of about $95 billion as defined by the national accounts, or 2.6 percent of GNP—these are preliminary figures—which was a historic high. Gross private savings were 18.4 percent of GNP, which also is a historic high for the United States, leaving aside World War II.

Senator Mathias. May I interrupt? You say it is a historic high. What was the previous historic high in the modern era?

Mr. Cooper. The previous high was in the 17.7-, 17.8-percent area, something like that. I am sorry. Are you talking about the current account deficit?

Senator Mathias. Current account.

Mr. Cooper. Well, 1983 was the previous high, and that was 1.1 percent of the GNP. If you go back to 1978——

The Chairman. How much in dollars?

Mr. Cooper. $35 billion. If you go back to 1978 you get the high before that, and that was $15 billion, and that was seven-tenths of 1 percent of GNP. So it is not just marginally a high. It is a striking high.

Senator Mathias. A dramatic high?

Mr. Cooper. A dramatic high, yes.

Senator Mathias. Thank you. And excuse me. I did not mean to interrupt you.

Mr. Cooper. Investment in the United States was 17.4 percent of GNP, which is higher than the average year, but it is typical for a boom year, which 1984 was. So we have exceptionally high savings and normally high investment for a boom year, but the deficit on Government account, and I include now State and local government as well as the Federal Government, was 3.4 percent of GNP, which was down somewhat from 1983, but it was nearly a historic high, if you leave aside 1983 and 1975.

Under these circumstances, the United States was bound to have a large trade deficit. Paradoxically, additional investment stimulated by additional tax concessions to investment, which are frequently urged by the business community as a means to become more competitive internationally, would actually worsen the trade balance during the period in which the investment is taking place, both by increasing investment relative to savings and by increasing the budget deficit.

The same kind of development, but with different configuration, developed in Japan. Private savings and investment rates have been considerably higher in Japan than in the United States over the last three decades. And on average, private savings and investment were roughly equal to one another until 1975.

Since 1975, Japanese domestic investment fell sharply and has remained low relative to previous Japanese experience. Japan greatly extended its social welfare program in the early 1970's, and that, combined with the economic slowdown, produced large government deficits in Japan, reaching over 4 percent of GNP in 1979. Since then, it has been Japanese policy to reduce the budget deficit, but private savings have remained high, around 27 percent of GNP, and well in excess of investment. So a large current account surplus emerged in 1981, and by 1983 it had reached 2 percent of GNP, and last year it is estimated to have been nearly 3 percent of GNP.

Now, how is it that these movements in savings and investment, which seem so different from trade balance, get translated into trade surpluses or deficits? A simple version of the answer is that the excess private savings of Japan, to take that example, to the extent that it could not be satisfied by government bonds, sought investment abroad. This foreign investment in turn put downward pressure on the yen which depreciated and made Japanese goods more competitive in world markets.

In contrast, in the United States a combination of Government deficits and private investment in excess of private savings strengthened interest rates and thereby attracted capital from abroad, thus leading to an appreciation of the dollar and worsening the competitive position of American products. So that in these days of flexible exchange rates, a principal equilibrating mechanism is the movement in the exchange rate.

The link between the overall trade position and the overall savings investment behavior is inescapable, and no fiddling around with particular trade policies or practices will get around it. For instance, the current proposal for a U.S. import surcharge to deal with the trade deficit would improve the trade balance mainly through the increased revenue to the Government. And the increased investment that some proponents want it to stimulate would undermine even that improvement if the investment were not accompanied by higher private savings.

I turn now to the future, and we can ask how sustainable is the current situation; is it bound to lead to a collapse? In my judgment it might lead to a collapse at any time, but it need not do so in the foreseeable future.

The United States is drawing about 5 percent of the gross savings in the rest of the world into this country to sustain its present level of investment and its Government deficit. That is historically a very large number, but it is not an insupportable one, particularly given the large excess savings in Japan. So long as dollar assets offer security and attractive yields, I could imagine that the rest of the world would be willing to lend to the United States on that scale for a number of years.

However, increasing external debt means that the debt service of the United States will rise over time. Americans pay foreigners roughly 10 percent for the money we borrow. It represents a future claim on U.S. output. This would be fine if Americans were investing these funds at a rate of return of, say, 15 percent. We would come out ahead that way. That would increase American GNP by more than we would have to pay to service the debt.

But we are not now borrowing to finance additional investment. As I have already said, the investment rate during 1984 is about what it has been in other boom years over the last 25 years. The real difference at present is the large U.S. Federal budget deficit. Social insurance payments are almost matched by payroll tax revenues. Defense spending is just under one-half of total Federal Government expenditures, if one leaves aside social insurance and interest payments. And defense spending has risen by over $90 billion since 1980.

One useful way of looking at the matter is that the United States is borrowing from foreigners to cover the incremental defense budget since 1980, thereby relieving Americans from having to tax themselves to pay for increased defense spending. But we have to pay for this debt in the future out of our future income which, as I say, we are not investing more than normal to increase.

Now, I am told to wind up, so I will close my statement by suggesting that I think the current situation, while possibly sustainable for some years, is an undesirable one, and it follows from what I have said that the way to deal with it is to reduce the U.S. Federal budget deficit. A precipitate reduction in that deficit, which does not look like it is about to happen, would be undesirable. It would throw the world into a recession which would set back other industrial countries and the developing countries who are barely squeaking their way through the debt problem.

But it is extremely important, as a matter of foreign as well as domestic economic policy for the United States to get on a path of gradual budget deficit reduction which is real and is sustainable.

Thank you, Mr. Chairman.

[Mr. Cooper's prepared statement follows:]

February 1985

U.S. Policy and the World Economy

Richard N. Cooper
Harvard University

We are now recovering from the worst economic downturn in fifty years. The impetus to recovery is being provided by the United States and to a lesser extent by Japan. Europe is still in a growth recession--positive growth, but not great enough to keep unemployment from rising--and many less developed countries are still in a period of retrenchment due to heavy debt burdens and still weak international terms of trade. The OECD forcasts a modest growth of nearly 3 percent for 1985.

The dominant feature of the world economy today is the huge U.S. deficit in its international trade in goods and services, reckoned at around $100 billion for 1984. The deficit in merchandise trade was $123 billion. These are historically unprecedented levels, both in dollar terms, and as a share of exports (over 25 percent) or GNP (about 2 1/2 percent). The last major deficit of the United States, a cause of so much alarm in the financial community in 1978, was $15 billion dollars, one-seventh the size of the current deficit, and only 0.7 percent of GNP. There were large net unrecorded receipts in 1984, so the true current account deficit may be somewhat lower than $100 billion, but most of these unrecorded receipts are believed to be capital inflows.

This deficit, and its rapid growth in 1983 and 1984, has a variety of effects. Other things being equal, it slows the growth of the U.S.

economy and acts as a drag on U.S. recovery. But by the same token it also helps keep inflation in check, by providing a flow of imports to satisfy rising U.S. demand. Finally, not least, it is the main mechanism by which U.S. economic recovery gets transmitted abroad. The rapid rise in U.S. imports provides welcome stimulus to other industrial countries, which have also been in a slump, and provides welcome foreign exchange earnings to the debt-ridden countries of the world.

Why is the deficit so large? Three reasons are usually mentioned: 1) There has been exceptionally rapid U.S. recovery from the 1982 slump, whereas other industrial economies have lagged behind. Thus U.S. imports have risen much more rapidly than U.S. exports due to this phasing of economic activity 2) Many developing countries, especially those in Latin America which historically has been a major market for U.S. exports, have tightened their economies considerably in order to cope with their own worsened balance-of-payments positions, which in turn were due in part to a drying up of inflows of capital, in part to high world interest rates, and in part to the world slump itself and a deterioration of their terms of trade. 3) Not least, the U.S. dollar has been extremely strong relative to other major currencies, roughly 40 percent stronger in real terms since 1980.

Why is the dollar so strong? Three reasons in turn are given for that: 1) The United States is a safe haven for capital from around the world, so funds flow in seeking political or economic security and drive up the value of the dollar. 2) Tight monetary policy and expansionary fiscal policy in the United States, taken together, raise U.S. interest rates and draw in capital from around the world. The inflow of capital in turn pushes up the value of the dollar. 3) We are in a speculative bubble in which investors around the world are bullish on the dollar mainly because everyone else is bullish and market strength feeds market strength. Although all recognize that the value of the dollar is unsustainably high in the long-run, each investor/speculator feels he can get out before the crowd does.

Academics have become highly specialized, and the first of these reasons requires a political scientist for verification, the second an economist, and the third a social psychologist. True to my profession, I put greatest weight on the second of these factors. I entertain considerable skepticism about the first. A search for political safely might have explained an outflow of funds from France and Germany in 1981, due to the election of a Socialist government and serious tensions over Poland, respectively. But it is difficult to explain an outflow of British funds at that time, with its new found oil and its most conservative and pro-business government in anyone's memory, or from Japan which remains as secure as it was in the 1960s or 1970s, and indeed whose economy is often viewed, with exaggeration, as the major powerhouse in the world today. It is also difficult to believe that continental Europeans are still seeking mainly safe haven with their funds.

I am inclined to give some credence to the third factor. I believe that financial communities, like most communities, can get absorbed in their own internal dynamics and avoid paying attention, for a while, to the broader context in which their decisions are being made. Dollar strength may well be feeding on itself. But I give greatest weight to U.S. macroeconomic policies in combination (since an exchange rate is necessarily anchored in at least two countries) with relatively tight fiscal policy in most other major countries in recent years.

If this judgment is correct, it suggests an intimate although complex relationship between U.S. fiscal policy, the dollar exchange rate, and the U.S. trade balance. The current configuration of policies here and abroad is resulting in exceptionally severe competition for U.S. firms at home and abroad, hurting both U.S. exports and firms that are in direct competition with imports.

We hear alot these days, from many quarters, about unfair competition from other countries. Foreign competition is unquestionably acute. In such circumstances, an American business firm or labor union will look much more closely at foreign practices, and not surprisingly they discover that foreigners do things differently from the way Americans do. Although these different foreign practices have often existed for many years, American firms and unions are now saying "we can't compete with that" and they appeal to the Administration or to Congress for protection against the offending practices. This is an understandable but myopic view of what is going on. Indeed, it reflects a fundamental analytical error that underlies much of even informed discussion with respect to so-called unfair trade practices and other policy distortions to international trade flows. That is the supposition that the overall trade balance, and lying behind that economic growth and employment, are determined or strongly influenced by the foreign practices that are typically singled out for admiration or condemnation, i.e. by policies or practices that limit particular imports or promote particular exports. This error is an example of the "fallacy of composition," whereby summing up a number of separate actions, each with well-defined effect--e.g. enlarging the Japanese import quota on citrus will surely lead to larger Japanese imports of citrus products--will not in fact have the expected overall effect. Concretely, the Japanese could remove every policy measure and alter every practice foreigners point to as restricting imports, and the consequences would not involve a reduction in the large Japanese trade surplus, and might not even result in an overall increase in Japanese imports. The reason is that a country's balance on trade in goods and services is determined by the difference between national saving and national investment, and it is only insofar as actions influence savings and investment that they can influence the trade balance:

$$X - M = S + (T - G) - I$$

Here the difference between exports (X) and imports (M) equals net foreign investment (unilateral transfers are neglected), and net foreign investment in turn must equal the difference between national saving (= private sector saving (S) plus the government operating surplus (T - G)) and national investment (I). This relationship is an accounting identity, from the definition of the concepts in the national accounts; decisions that affect one of these aggregates automatically must affect one or more others in a consistent way.

This relationship is of fundamental importance in assessing overall trade performance. While lifting the Japanese citrus quota will almost certainly raise Japan's imports of citrus, and will probably raise overall Japanese imports (but by less than the increase in citrus imports), it would not reduce the large Japanese trade surplus except insofar as lifing the quota affected national savings and/or investment, i.e. probably not at all, or only negligibly. Given a large savings-investment imbalance, a rise in one particular import will be offset by a decline in other imports and/or a rise in exports. Paradoxically, it is even conceivable that a stripping away of all Japan's protective practices[1] would lead to a rise in the trade surplus rather than a decline, if the sudden import competition reduced Japanese investment more than it reduced saving; but since "saving" includes corporate earnings, it could equally plausibly reduce the trade surplus by reducing corporate profits but at the same time stimulating corporate investment, in order to survive in the new, more competitive environment. The point is that to assess the overall impact one must look beyond the commodities immediately affected by the change in policy, whether it be import restriction or export promotion.

The significance of this in the present context is that since 1981 the United States has had a large and rapidly growing trade deficit, whereas Japan and several European countries have developed large surpluses. This trend in overall imbalances has had a strong influence on the rise in import shares in the U.S. market and the decline in U.S. export shares, and correspondingly on the competitive pressures on American firms. But they arise from overall macro-economic developments, not from "unfair trade practices," however many of those there might be. It is of course unrealistic to expect industries affected by severe foreign competition at home or abroad to sort out the macro-economic influences from the specific foreign practices affecting the industry or commodity in question. But for purposes of addressing policy it is essential to make this distinction; failure to do so is bound to lead to frustration, since even a vigorous use of the wrong instruments will not achieve the desired objective.

---

[1] I use the term "practices" since much difficulty in import penetration in Japan is due, in my judgment, less to governmental policy than to deeply engrained purchasing practices by Japanese firms and mid-level ministry officials.

In 1984 the United States ran a current account deficit of $95 billion, or 2.6 percent of GNP, a record high. Gross private savings were 18.4 percent of GNP, also a record high. Gross investment was 17.4 percent of GNP, typical for a boom year. But the deficit on governmental account (including state and local governments) was 3.4 percent of GNP, down from 1983, but nearly an historic high, excluding the Second World War. Under these circumstances, the United States was bound to have a large trade deficit. Paradoxically, additional investment stimulated by additional tax concessions to investment, frequently urged by the business community as a means to become more competitive internationally, would actually worsen the trade balance during the period of investment, both by increasing investment and by increasing the budget deficit.

Indeed, in 1984 investment rose dramatically but characteristically as the economy moved into the second year of economic recovery. The deficit on government account dropped somewhat as revenues rose. Savings jumped to an historic high, but not by enough to cover the additional investment--typical for a boom year--so the trade deficit rose (see Table, which also includes data for 1966, 1973, and 1979, earlier boom years).

Relation Between U.S. Trade Balance and National Savings and Investment

	1966	1973	1979	1983	1984^p
	(percent of GNP)				
Net exports	0.4	0.5	-0.1	-1.0	-2.6
=					
Gross private savings	17.0	17.2	16.8	17.3	18.4
+					
Government budget surplus^a	-0.2	0.6	0.6	-4.1	-3.4
-					
Gross domestic investment	16.6	17.3	17.5	14.3	17.4

p: Preliminary
a: Federal, state, and local

Note: Columns may not show equality due to rounding errors or small statistical discrepencies

Source: Calculated from Council of Economic Advisers, Economic Report, 1985.

An analogous development occurred in Japan. Private savings and investment rates have been considerably higher in Japan than in the United States over the past three decades, and on average roughly equal to one another until 1975. Investment fell sharply then, and has remained low by Japanese standards since then. Japan greatly extended its social welfare programs in the early 1970~~s,~~ and that combined with an economic slowdown produced large government deficits, reaching over 4 percent of GNP in 1979. Since then it has been Japanese policy to reduce the budget deficit; but private savings have remained in excess of investment, so a large current account surplus emerged in 1981, and by 1984 it had reached 2.8 percent of GNP.

How can these movements in savings and investment, inclusive of government, get translated into trade surpluses or deficits? A simple version of the answer is that the excess private savings of Japan, to the extent it could not be satisfied by claims on government (resulting from the budget deficit) sought investment abroad. This in turn put downward pressure on the yen, which depreciated and made Japanese goods more competitive in world markets. In the United States, in contrast, a combination of government deficit and private investment in excess of private savings strengthened interest rates and thereby attracted capital from abroad, thus leading to appreciation of the dollar and worsening the competitive position of American products both at home and abroad. So the main mechanism of equilibration was the exchange rate. Under a system of fixed exchange rates this pressure of an increase in net national savings cannot weaken the currency, so it reduces income (causes a recession) to the point at which the reduced savings and improvement in the current account balance (due to lower imports) preserve the equality between net national savings and net foreign investment. The recession may also put downward pressure on wages and prices, and improve international competitiveness in that way.

Either way, the link between the overall trade position and overall savings-investment behavior is inescapable, and no fiddling around with particular trade policies or practices will get around it. For instance, the current proposal for a U.S. import surcharge would improve the trade balance mainly through the increased revenue to the government (reducing the dissaving by the government), and the increased investment that some proponents want it to stimulate would undermine even that improvement if the investment were not accompanied by higher private savings.

Of course, from the perspective of an individual industry these macro-economic developments seem unimportant relative to the industry-specific policies of countries; and it is true that such policies can strongly influence the commodity structure and geographic direction of trade. But the industry perspective is myopic; in assessing the impact of industrial policy on trade as a whole, it is crucial to take into account the macro-economic environment.

How sustainable is the current situation? Is it bound to lead to a collapse? In my judgment, it might lead to a collapse but it need not do so in the foreseeable future. The United States is drawing about 5 percent of gross savings in the rest of the world to sustain its present level of investment. That is historically a large number, but not an insupportable one, especially given the large excess savings in Japan. So long as dollar assets offer security and attractive yields, I can imagine that the rest of the world would be willing to lend on that scale for a number of years.

However, increasing external debt means that the debt service of the United States will rise over time. Americans pay foreigners roughly 10 percent for the money they borrow, indefinitely. It represents a future claim on U.S. output. This would be all right if Americans were investing at a rate of return of 15 percent. That would increase the American GNP by more than Americans have to pay to service the debt. But the United States is not now borrowing to finance additional investment. The investment rate during 1984 is about what it has been in other boom years over the past 25 years, although it is somewhat higher than the average level of about 16 percent of GNP, taking vigorous years and slack years together.

The real difference at present is the large U.S. federal budget deficit. Social insurance payments are almost exactly matched by payroll tax revenues. Defense spending is just under half of total federal government expenditures less social insurance and interest payments, and has risen by over $90 billion dollars, or by 70 percent, since 1980. One useful way of looking at matters is that the United States is borrowing from foreigners to cover the incremental defense budget, thereby relieving Americans from having to tax themselves to pay for increased defense spending. The increased defense spending of course helps foreigners too, although they may not agree we need quite so much or quite what we are buying. But with the debt that we have accumulated to pay for this increased expenditure we create a continuing charge on American tax payers to pay the interest and possibly at some point to repay the principal. So by relieving

American tax payers of the burden now we are increasing the burden on tax payers in the future, with little or no investment to yield the income from which to service the debt. Unlike government debt that is held internally, this debt service is not merely a transfer among Americans, but a real reduction in future living standards for Americans as the payments must be made abroad.

As the U.S. debt service rises, Americans must borrow at ever greater rates to cover it, or else U.S. trade competitiveness will have to improve markedly to service the increasing net interest and dividend payments. It is hard to see how this can come about without a sharp drop in the value of the dollar in terms of other currencies at some point. Once the drop occurs, it may be precipitous, causing much turbulence in financial markets and in national economies. Indeed, such a drop could occur well before the burden of debt servicing forces it, if asset holders around the world decide they have reached the limits of how many dollar assets they will add to their portfolios. Since the large net capital inflow sustains the strong dollar, even a weakening of the rate of inflow could lead to a sharp decline in the dollar.

That decline of course will be welcome to much American industry, for it will relieve the extreme competitive pressure which they now feel from imports and from foreigners in traditional American export markets. But it will also be inflationary for the U.S. economy, paying back, as it were, the inflation reduction we borrowed from the future during the period in which the dollar strengthened so sharply. And it will not be welcome by industry abroad, which has come to enjoy the extensive sales not only in the United States but elsewhere around the world which can be made more easily at current exchange rates. By the same token, however, a drop in the dollar will provide some welcome anti-inflationary pressures in other economies. Probably the most important effect, though, is that if it comes rapidly it will create much uncertainty about where and when exchange rates will settle down, and hence will temporarily discourage investment both in the United States and elsewhere. It could contribute to a world recession.

There is another danger as well, and that involves the Senate much more directly. It is that American firms and labor will hurt so much that they plead successfully for protection against imports. On the argument made above, protectionist actions will not in fact help the overall U.S. trade position without raising savings or reducing investment. But of course particular industries do not look at it from that point of view. A particular industry can be helped by protectionist actions, and if that means hurting other, non-identifiable groups, that is simply viewed as a regrettable side effect. We must beware taking protectionist actions in the name of such vague but attractive sounding labels as "fair trade" and "achieving a level playing field," actions that are protectionist in effect and will be perceived abroad as being protectionist no matter what the detailed refinement of their rationale in the U.S. political context. To the extent that major imports are in fact cut by such actions, that is likely to make the dollar even stronger, partly by cutting imports but also partly by stimulating defensive inflows of foreign capital to protect foreigners' markets in the United States. It is possible to imagine a cumulation of piecemeal actions, each designed to effect favorably some sector, that in fact end up leaving everyone worse off when everything has settled down.

A major move toward protection--and we have already seen quite a bit of it, despite the Administration's rhetorical commitment to liberal trade--would have major consequences for foreign policy. It could undermine our relations with our major allies in Europe and Japan. It could also make impossible management of the global debt. If the world stays on the path of steady growth, no major change or preferably some decline in interest rates, no major change or preferably some decline in the value of the dollar, and open markets, most debt-ridden countries will be able to make it through the current difficult period. The worst is over, except for a number of smaller, mainly African, countries. Each case has been handled on the basis of its distinctive characteristics, but within the context of a more or less common framework that has evolved over the years. But of course most debt-ridden countries are going through a difficult economic retrenchment in order to service their debts. The potential for radicalization is present when developing economies are squeezed to satisfy foreign creditors, the U.S. government, and the IMF. If the developed countries, and in particular the United States, seem to put insuperable obstacles in the path of servicing these debts--which must be done through some combination of increased exports from and reduced imports into those countries--their governments will be forced off the narrow difficult path they are now on. It does not have to be emphasized here that symbolism is as important as actual substance where political feeling and political stability are concerned. As former Secretary of State Henry Kissinger has said: "The vulnerability of American policy to protectionist pressures...remains a serious weakness of the American system...Protectionism is above all an untenable posture for a nation that seeks to be the leader of the alliance of industrial democracies...." (The White House Years, 1979, p.340)

For all of these international reasons, as well as domestic ones that are less directly the concern of this Committee, the United States should take sure steps to reduce the government budget deficit in order to reduce the U.S. trade deficit. But it should do so gradually, so as to avoid generating a new world recession, which would make things even worse. That should ease long-term interest rates somewhat, and they should be eased further in that context with some additional help from monetary policy.

The CHAIRMAN. Thank you very much, Dr. Cooper.

In announcing the witnesses this morning I failed to mention that Dr. Cooper is the Boas professor of international economics at the Center for International Affairs at Harvard University in Cambridge, MA.

Our next witness, Martin Feldstein, is now the president of the National Bureau of Economic Research in Cambridge, MA.

Dr. Feldstein, would you proceed with your testimony?

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MA

Mr. FELDSTEIN. I would be happy to, Senator.

You have managed to disguise the fact that Dick and I are also colleagues as professors of economics at Harvard.

The CHAIRMAN. Exactly.

Mr. FELDSTEIN. I am certainly delighted to be here, and I am very pleased that you have chosen to examine the economic aspects of foreign policy at this early stage in your deliberations.

I have a prepared statement which I will leave for the record. What I would like to do is to summarize part of it and read part of it.

The statement begins by discussing the strong dollar and our current dependence on the net capital inflow from abroad. Last year we had a capital inflow of nearly $100 billion, enough to finance half of our budget deficit, or about 40 percent of all net investment in the United States.

Unfortunately, at the present time we need that kind of capital inflow if we are to maintain investment in plant and equipment and in housing in this country in the presence of the incredibly large Government borrowing. But to get that capital inflow requires the equally large trade deficit, which is doing serious damage to American industry ranging from agriculture to basic industries like steel and chemicals to high technology.

I think it is important to ask what will happen when we do not have that capital inflow from abroad. If we did not have that capital inflow for last year, net investment in this country would be about 40 percent lower than it actually is. Real interest rates would have to be much higher to balance that investment with the very low level of savings now being generated in the United States. Because net of Government borrowing and net of depreciation, domestic savings are now at the remarkably low level of only 3 percent of GNP, because Government borrowing at 5 percent of GNP is absorbing more than half of all of the private, State, and local government savings being generated in the economy.

Why might the capital inflow from abroad actually decline? At some point I think foreigners will become unwilling to hold increasing amounts of dollar securities despite high real interest rates that they get in the United States, because the more of their portfolios that they put into dollar securities, the more risk that they are taking.

Since 1981, foreign private investments in the United States have increased by more than 50 percent, so the point of increasing risk is getting closer and closer. Indeed, last year a substantial part of the capital inflow into the United States was achieved not by inducing foreigners to put more money here, but by a cutback on U.S. loans abroad.

I am not sure whether that massive return of U.S. lending by our banks and other corporations can continue in 1985 and beyond. If not, then the only way we can go on financing the current trade deficit and the current capital inflow is by sharply higher interest rates. Eventually, the capital inflow has to stop, and when it does, the dollar will come down. If the Government still needs to borrow substantial amounts, investment in this country will fall sharply. And that is why I think it is so important for us as a domestic matter to shrink budget deficits by legislation enacted this year. Moreover, the sooner we see that kind of legislative action, the sooner the dollar will come down and we will be able to get improvements in our trade balance.

I think a great danger both to our economy and to our foreign policy of persistent trade deficits is that they foster a return to protectionist policies. Although protectionist policies that close American markets to foreign competition or that subsidize U.S. exports can help the politically favored industries, they do so at the expense of all other industries.

For example, the current restrictions on auto imports keep the dollar higher than it would otherwise be, and thereby those auto restrictions hurt American farmers, and they hurt other American firms that must compete in world markets. A return to widespread protectionism would also penalize American consumers by denying them access to imports at favorable prices.

In addition, protectionism is never a one-sided affair. If the United States pursues protectionist policies, our trading partners will inevitably retaliate, and moreover, they will feel morally justified in protecting and subsidizing their own industries.

American business and labor will suffer as we lose export markets and are denied the opportunity to do those things that we in this country can do best. Countries that are hurting each other in a trade war are not likely to be very effective political allies. Protectionist policies are therefore likely to have serious consequences for our foreign relations as well as for our domestic economic well being.

Our unprecedented trade deficit with Japan has been a particularly severe source of friction with that government. This growing conflict is important, not only because Japan is our largest overseas trading partner, but even more so because Japan is the second largest industrial democracy and the linchpin of our foreign policy in the Far East.

It would simply be a disaster if the current trade conflict were permitted to undermine our friendly political and economic relationship with Japan in the years ahead. Although Japan has a $45 billion merchandise trade surplus with the United States and a $30 billion trade surplus with the world as a whole, sophisticated observers have come to realize that it is just plain wrong to blame our overall trade deficit on Japan, or indeed to focus on any bilateral trade deficit in a multilateral world.

Moreover, the Japanese yen has actually declined less since 1980 in relation to the dollar than other industrial currencies, and our bilateral position has declined less with Japan than with either the European Economic Community or with Latin America.

The fundamental reason for Japan's trade surplus with the rest of the world is, as Dick Cooper said, that Japan has an extremely high savings rate. Gross saving in Japan is over 30 percent of their GNP or 50 percent higher than the average of the other OECD countries.

Of course, the combination of Japanese investment and the budget deficit of the Japanese Government is not enough to absorb all of that saving at home. The Japanese must invest abroad as well. This overseas investment has to be matched by a corresponding trade surplus for Japan, or to put it in a slightly different way, the high Japanese savings rate results in extremely low rates of interest on Japanese bonds.

Long-term corporate bonds in Japan now yield only about 6¼ percent, less than half of what comparable risk bonds would yield in this country. So it is not surprising that Japanese investors want to invest overseas. That process of selling yen and buying foreign currencies to finance that overseas investment depresses the yen and gives Japan its trade surplus.

The Japanese could reduce their trade surplus if they pursued policies at home to increase investment in Japan. Improved tax incentives for investment would induce Japanese firms to invest more at home, instead of seeking foreign investment opportunities.

Moreover, and I think more directly relevant to this committee, investment in Japan could be increased if the Japanese Government could reduce the restrictions that currently block American and other non-Japanese firms that would like to invest in Japan.

Although the Japanese have recently acceded to our Government's pressures to allow increased borrowing in Japan by non-Japanese firms, this actually tends to depress the yen and therefore to strengthen the Japanese competitive position. Our Government should now press the Japanese to permit direct investment in Japan by U.S. firms on the same basis that Japanese firms enjoy in their own country.

It is frequently suggested that Japan's favorable trade balance would be reduced if Japan increased its extremely low level of defense spending. But that, in fact, would only be true to the extent that higher defense spending in Japan increased Japan's budget deficit and thereby absorbed more of the private savings that are now going abroad.

Because of Japan's demographic situation, the national habits of thrift, and the institutional inducements to save, the Japanese are going to continue for many years to save more than they invest in Japan. The result will continue to be a capital outflow to the rest of the world, and therefore a trade surplus. And in a world where capital is scarce, we should learn to regard that as an advantage rather than a problem.

But there is a serious trade issue that has deep political implications for our relationship with Japan and, more generally, for our political relations in Asia. Virtually every American firm that does business or tries to do business in Japan complains that the combination of tariffs and nontariff barriers prevents the sale of American products and services in Japan, even when they are clearly better in price and quality than the Japanese competition. American business is frustrated, indeed furious, about the way in which the Japanese Government protects and nurtures Japanese industry.

A change in Japanese Government policy would be good for American firms and workers because it would allow us to expand markets for products where we have already incurred the costs of acquiring sophisticated technical know-how and because it would allow us to concentrate more of our energies on doing those things that we as a Nation do best.

The net result might not be a reduction in the total U.S. trade deficit or even in the total Japanese trade surplus, but it would shift the mix of exports and imports in a desirable direction. And even more, a reduction in the protectionist policies of the Japanese Government and of Japanese firms would remove a source of irritation that could eventually undermine the very important political alliance between Japan and the United States.

To encourage such antiprotectionist policies by the Japanese, I think we should get our own house in order by agreeing not to request an extension of the so-called voluntary restraints on Japanese auto sales in the United States.

The current restriction substantially raises the price that American consumers have to pay for both domestic and foreign cars. But the damage that it causes is more fundamental, because it undermines the basic policy of the United States that trade restrictions are justified only for national security reasons or when other countries are unfairly subsidizing their exports. Whatever case might once have been made for aiding the depressed auto industry can certainly not be sustained after the strong profit performance of that industry last year.

Finally, I would like to turn to Europe and the situation there as it is affected by our policies in the United States. European leaders at summit and other meetings have complained very loudly about the fact that our large budget deficits have caused high real interest rates and a massive capital inflow to the United States.

Although the same leaders are also prepared to admit that the U.S. trade deficit has increased demand for their exports, they are really unanimous in their call for lower U.S. budget deficits. The European complaint about U.S. budget deficits is I think more than just the seizing of a convenient scapegoat for their own weak economic performance.

Under current European economic conditions, the rapidly rising dollar, the net capital flow to the United States, really are substantial impediments to an improved economic performance in Europe. Consider first the effects of the rising dollar and consequent fall in European currencies. Just as the stronger dollar is bringing reduced inflation in the United States, the falling French franc, German mark, and British pound are putting upward pressure on prices in those countries.

To prevent that pressure from initiating a new round of domestic inflation in Europe, the governments in each of those countries have been forced to pursue a tighter monetary policy at home than they would otherwise have chosen. This tighter monetary policy has prevented a strong recovery in Europe and has contributed to the continually rising rate of unemployment that now plagues all of the major European nations.

There has been no increase in total employment in Europe since 1970 and the unemployment rate there has increased from less than 3 percent to nearly 11 percent last year. It is not surprising that European political leaders are frustrated and are annoyed by an American budget policy that they see has contributed to America's strong economic expansion, while impeding their own expansion.

If I could make one last point before concluding, it would be that the dramatic rise in the net capital flow to the United States has also made it more difficult to reduce European unemployment. I think it is now widely recognized that one of the reasons for the high unemployment rate in Europe is that labor market rigidities have kept real wage rates too high there during a period of reduced productivity increases.

To remedy this, the rate of increase of European real wages must be slowed relative to future increases in productivity. The high level of European unemployment has recently caused some decline in real wages in Europe, and this is clearly a slow and a painful process.

The gap between productivity and wages could be closed more rapidly and with less pain if productivity in Europe were rising faster. One way to achieve that would be a higher rate of investment in plant and equipment. The European leaders see the net capital flow to the United States as denying Europe the capital that could raise productivity and lower unemployment.

They are frustrated that the U.S. budget deficits are depressing European productivity and raising European unemployment through a change in net capital flows that at the same time mitigates the adverse effects of our budget deficits on U.S. investment and productivity.

I think it is difficult to judge the actual magnitude of these adverse effects, but there is no doubt that current European perceptions create a climate of ill will, in which European governments can believe that the pursuit of protectionist policies aimed at increasing employment in Europe is a morally legitimate response to the harm being done by American budget deficits.

Thank you.

[Mr. Feldstein's prepared statement follows:]

ECONOMIC POLICY AND FOREIGN RELATIONS

Martin Feldstein

Testimony before the Senate Foreign Relations Committee

February 28, 1985

Thank you, Mr. Chairman. I am delighted to appear before this very distinguished Committee. I am particularly pleased that you have chosen to examine the economic aspects of our foreign policy at this early stage in your deliberations.

It was not so long ago that economic policy was essentially a domestic issue and that foreign policy focussed almost exclusively on non-economic questions. In the quarter century after World War II, our trade with the rest of the world was relatively small and always in surplus. Now, as you know, the United States has an unprecedented merchandise trade deficit of more than $100 billion and we are relying on foreign capital to finance nearly half of all the net investment in the United States. Moreover, our trade deficit and the capital flow to the United States have profound implications for our political relations with other nations throughout the industrialized and developing world.

This morning I will begin by talking about our trade imbalance, its implications for our relations with other countries, and the appropriate policy for dealing with it. I will discuss in particular our relations with Japan and with Europe. I will then turn to the special problems of the LDC debtor nations.

Our Trade Imbalance

Our vast trade deficit means that several important American industries that sell products in foreign markets or compete with imports from abroad are not sharing fully in our economic recovery. The businesses that are suffering range widely from agriculture to basic industries like steel and chemicals and to high technology firms.

The very serious adverse nature of the trade deficit and of the strong dollar that is its principal cause may not be fully appreciated because they have also brought some temporary advantages to the American economy. The 1984 trade deficit was financed by a $95 billion net inflow of capital from abroad. That inflow of capital nearly doubled the funds available for net investment in the United States and kept real interest rates from moving substantially higher. In addition, the rising dollar lowered the prices of imports and of competing American products by enough to cut our overall inflation rate by at least one percentage point last year.

There is a real danger that the capital inflow and the rising dollar are giving us a false sense of well-being. The dollar must eventually decline by enough to offset most of the nearly 70 percent increase that has occurred since 1980. When it falls, there will be upward pressure on prices in the United States that could return us to the stagflation conditions of the 1970s. And with a smaller capital inflow from abroad, investment in the United States could be substantially lower and real intrest rates significantly higher unless the reduced capital inflow is offset by a fall in government borrowing.

The trade deficit and the capital inflow have now made the United States a debtor nation. In the future, we as a nation will have to give up some of each year's production to service our public and private debts to the rest of the world. To pay for our current profligacy, our children will not be able to keep all that they produce.

But the greatest danger in our current trade deficit is that it may foster a return to protectionist policies. Although protectionist policies that close American markets to foreign competition or that subsidise U. S. exports can help the politically favored industries, they do so at the expense of all other industries. For example, the current restrictions on auto imports keep the dollar higher than it would otherwise be and thereby hurt American farmers and others who must compete in world markets. A return to widepread protectionism would penalize American consumers by denying them access to imports at favorable prices and would undermine the natural vitality and competitiveness of American business.

Protectionism is never a one-sided affair. If the United States pursues protectionist policies, our trading partners will inevitably retaliate and will feel morally justified in protecting and subsidizing their own industries. American businesses and labor will suffer as we lose export markets and are denied the opportunity to do those things that we in this country can do best.

Countries that are hurting each other in a trade war are not likely to be effective political allies. Protectionist policies are therefore likely to have serious consequences for our foreign relations as well as for our economic well-being.

The Dollar

To remedy our trade deficit, the real value of the dollar must decline to reverse its nearly 70 percent rise in the past five years. Although our trade deficit also reflects the strength of the American recovery and the ability of the debtor nations to become less reliant on foreign loans, we would not want to reverse either of those developments. And although a stronger recovery in Europe and Japan would help to shrink our trade defict, the potential magnitude of the gain from that source is rather small. So the dollar must be substantially reduced if we are to return to at least an approximate balance of trade.

The sharp increase in the dollar has occurred because dollar securities and dollar bank deposits have become much more attractive in comparison to investments in other currencies. The pricipal reason for this increased attractiveness has been the sharp rise in the real interest rate on medium-term and long-term dollar investments relative to the returns available elsewhere. For example, although Germany has an inflation rate similar to that in the United States, interest rates on corporate bonds are 5 percentage points lower in Germany than in the United States. Although everyone expects that the dollar will eventually decline, investors are willing to hold dollar bonds because the extra yield on American corporate bonds would be enough in just a half-dozen years to offset a one-third fall in the dollar's value relative to the German mark.

The attractiveness of dollar securities has also been enhanced by the pursuit of a monetary policy that has reduced the risk of inflation in the

United States. In addition, the reduction in borrowing by the debtor nations has reduced the supply of dollars in world financial markets and thereby increased the dollar's value. Moreover, the political stability of the United States encourages individuals and institutions around the world to place their investments in dollar securities. Although it is important to reduce the dollar's value, it would clearly be wrong to do so by increasing the risk of inflation in the United States, by inducing the LDC's to go more deeply into debt, or by weakening the political stability of the United States.

The only appropriate policy for reducing the overstrong value of the dollar and achieving a trade balance is therefore to reduce the level of real interst rates in the United States. The sharp rise in real interest rates since the beginnng of the decade is due primarily to the dramatic increase in the level of current and future structural budget deficits. Although the higher real interest rates also reflect an improved climate for business investment, the only desirable way to reduce real interest rates is by cutting these projected budget deficits. I believe that if Congress enacts legislation this summer that cuts the projected budget deficits to less than 2 percent of GNP by 1988 and that points to the likelihood of a balanced budget by early in the next decade, we will see a substantial decline in real interest rates and in the value of the dollar before the end of the year. By 1986 there would be a clear improvement in our trade balance.

Although a sharp reduction in real interest rates and projected budget deficits would bring an immediate decline of the dollar, we can say with confidence that the dollar must eventually fall even if budget deficits are not reduced. At some point, possibly as long as several years from now, foreign investors will become reluctant to continue putting a larger and larger share of their portfolios into dollar securities because the increasing risk of an unbalanced portfolio will outweigh the yield advantage of dollar securities. When that occurs, the dollar will fall. The longer the delay before the fall of the dollar, the more damage the overstrong dollar will do to our industries that are engaged in international trade. And if the dollar falls substantially before there is a resolution of the budget deficit, the reduced capital inflow will mean sharply higher interest rates and a sharp contraction of investment in housing and in plant and equipment.

Japan

Our unprecedented trade deficit has been a particularly severe source of friction with Japan. This growing conflict is important not only because Japan is our largest overseas trading partner but even more so because Japan is the second largest industrial democracy in the world and the lynchpin of our foreign policy in the far east. It would be a disaster if the current trade conflict were permitted to undermine our friendly political and economic relations with Japan in the years ahead.

Although Japan has a $45 billion merchandise trade surplus with the United States and a $30 billion trade surplus with the world as a whole, sophisticated observers have come to realize that it is wrong to blame our overall trade deficit on Japan or to focus on any bilateral trade deficit in a multilateral trading world. Moreover, the the Japanese yen has declined less since 1980 in relation to the dollar than other industrial currencies and our bilateral trade position has declined less with Japan since 1980 than with either the European Economic Community or Latin America.

The fundamental reason for Japan's trade surplus with the rest of the world is that Japan has an extremely high saving rate. Gross saving in Japan is over 30 percent of GNP, 50 percent higher than the average of the other OECD countries. Because the combination of Japanese investment and the budget deficit of the Japanese government is not enough to absorb all of that saving at home, the Japanese invest abroad as well. This overseas investment must, of course, be matched by a corresponding trade surplus.

Looked at in a slightly different way, the high Japanese saving rate results in extremely low interest rates on Japanese bonds. Long-term corporate bonds in Japan now yield only about six and a quarter percent. It is not surprising that Japanese investors want to invest overseas. The process of selling yen and buying foreign currencies to finance that overseas investment depresses the yen and gives rise to Japan's trade surplus.

The Japanese could reduce their trade surplus if they pursued policies that increased investment in Japan. Improved tax incentives for investment would induce Japanese firms to invest more at home instead of seeking foreign investment opportunities. Investment in Japan could also be increased if the Japanese government would reduce the restrictions that currently block American and other non-Japanese firms that would like to invest in Japan.

Although the Japanese have recently acceeded to U.S. pressures to allow increased borrowing in Japan by non-Japanese firms, this actually tends to depress the yen and strengthen the Japanese competitive position. Our government should now press the Japanese to permit direct investment in Japan by U. S. firms on the same basis that Japanese firms enjoy in Japan.

It is frequently suggested that Japan's favorable trade balance would be reduced if Japan increased its extremely low level of defense spending. This would in fact be true only to the extent that the higher defense spending increased Japan's budget deficit and thereby absorbed more of the private savings that are now going abroad. An increase in defense spending that is financed by higher taxes or reductions in nondefense outlays would have no effect on the trade deficit. Indeed, even if Japan increased its defense outlays by purchasing more American-made defense equipment, that would only change the composition of Japan's trade surplus and not its total magnitude unless Japan increased its budget deficit in the process.

Because of Japan's current demographic situation, the national habits of thrift, and the institutional inducements to save, I believe that the Japanese will continue for many years to save more than they invest in Japan. The result will continue to be a capital outflow to the rest of the world and therefore a trade surplus. In a world where capital is scarce, we should learn to regard this as an advantage rather than a problem.

But there is a trade issue that has deep political implications for our relationship with Japan and, more generally, for our political relations in Asia. Virtually every American firm that does business or tries to do business in Japan complains that the combination of tariffs and nontariff barriers prevents the sale of American products and services in Japan even when they are clearly better in price and quality than their Japanese competition. American business is frustrated and furious about the way in which the Japanese government protects and nurtures Japanese industry.

A change in Japanese government policy would be good for American firms and workers because it would allow us to expand markets for products where we have already incurred the costs of acquiring sophisticated technical know-how and because it would allow us to concentrate more of our energies on doing those things that we do best. The net result might not be a reduction in the total U.S. trade deficit or in the total Japanese trade surplus but it would shift the mix of exports and imports in a desirerable direction. And, even more important, a reduction in the protectionist policies of the Japanese government and Japanese firms would remove a source of irritation that could eventually undermine the very important political alliance between Japan and the United States.

To encourage such anti-protectionist polices by the Japanese, we should get our own house in order by agreeing not to request an extension of the so-called voluntary restraints on Japanese auto sales in the United States. The current restriction substantially raises the price that American consumers have to pay for both domestic and foreign cars. But the damage that it causes is more fundamental because it undermines the basic policy of the United States that trade restrictions are justified only for national security reasons or when other countries are unfairly subsidising their exports. Whatever case might once have been made for aiding the depressed auto industry can certainly not be sustained after the strong profit performance of the industry in 1984.

Europe

The current economic situation in the United States also has implications that could have long-term effects on our relations with our allies in Europe. European leaders at the Summit and at other meetings have complained loudly about the fact that our large budget deficits have caused high real interest rates and a massive capital flow to the United States. Although these same leaders are also prepared to admit that the U.S. trade deficit has increased demand for their exports, they are unanimous in their call for lower U.S. budget deficits.

The European complaint about U.S. budget deficits is more than the seizing of a convenient scapegoat for their own weak economic performance. Under current European economic conditions, the rapidly rising dollar and the net capital flow to the United States are substantial impediments to an improved economic performance in Europe.

Consider first the effect of the rising dollar and the consequent fall in the European currencies. Just as the stronger dollar is bringing reduced inflation to the United States, the falling value of the French franc, the German mark and the British pound is putting upward pressure on prices in those countries. To prevent that pressure from initiating a new round of domestic inflation, the governments in each of those countries have been forced to pursue a tighter monetary policy than they would otherwise have chosen. This tighter monetary policy has prevented a strong recovery and contributed to the continually rising rate of unemployment that now plagues all of the major European nations. There has been no increase in total employment in the European community since 1970 and the unemployment rate there has increased from less than 3 percent in 1970 to nearly 11 percent last year. It is not surprising that European political leaders are frustrated and annoyed by an American budget policy that they see has contributed to America's strong economic expansion while impeding their own.

The dramatic rise in the net capital flow to the United States has also made it more difficult to reduce European unemployment. It is widely recognized that one of the reasons for the high unemployent rate in Europe is that labor market rigidities have kept real wage rates too high during a period when the rising cost of energy and other raw materials has reduced the rate of productivity increase. To remedy this, the rate of increase of European real wages must be slowed relative to the future increase in productivity. Although the high level of European unemployment has recently caused some decline in real wages, this is clearly a slow and painful process. The gap between productivity and wages could be closed more rapidly and with less pain if productivity were rising faster. One way to achieve that would be a higher rate of investment in plant and equipment. The European leaders see the net capital flow to the United States as denying Europe the capital that could raise productivity and lower unemployment. They are frustrated that the U.S. budget deficits are depressing European productivity and raising European unemployment through a change in net capital flows that at the same time mitigates the adverse effects of our budget deficits on U.S. investment and productivity.

It is difficult to judge the actual magnitude of these adverse effects. But there is no doubt that current European perceptions create a climate of ill will in which European governments can believe that the pursuit of protectionist policies aimed at increasing employment in Europe is a morally legitimate response to the harm being done by American budget deficits.

A substantial reduction in our future budget deficits will certainly not eliminate all of the sources of economic friction between the United States and Europe or cause European governments to abandon all of their protectionist policies. But it would undoubtedly create a climate of greater cooperation within which the United States could hope to be more effective in persuading European governments to abandon their import barriers and production subsidies.

European thinking about economic policy has changed significantly and is now at a very important crossroad. European governments are moving away from the belief, characteristic of so much of European thinking since World War II, that extensive government intervention in the economy is desirable. European leaders are now concluding that excessive government intervention has impeded economic change, reduced incentives, and created rigidites that diminish productivity and slow the rate of innovation and growth. There is a new faith in the role of the market and in the potential contribution of individual initiative and private industry.

This is a positive development not only because it can contribute to the long-term well being of the people of Europe but also because it can strengthen the political ties between the United Staetes and Europe. Our long-term political relations with the countries of Europe are likely to be better if our economic systems are more alike. Moreover, successful market economies require and encourage the same virtues of individualism and liberty in the economic sphere that we value as fundametal rights in the political sphere. A country that is committed to a free market economy must maintain a free and open society.

LDC Debt

The final subject that I want to discuss this morning is the prospects of the debtor nations of the developing world. I need not comment at length on our stake in this problem. The public and private debts of these countries to U.S. banks and other corporations exceed $300 billion and they provide the market for about one-fourth of all American merchandise exports. But our concern goes beyond these economic interests. The principal LDC debtor nations are our friends and neighbors in Latin America. The way that they deal with their international debts will have profound effects on the political stability of the Western hemisphere and ultimately on the strategic balance of our region.

Fortunately, there has been great progress in dealing with the international debt situation since Mexico's announcement in the summer of 1982 precipitated the first stage of the debt crisis. The two nations with the largest foreign debt, Mexico and Brazil, have now achieved very favorable trade surpluses. Although this was initially accomplished by contracting imports and therefore overall economic activity, both countries are now enjoying economic expansion and are maintaing their favorable trade balances by expanding exports.

The expansion of debtor country exports is the key to the successful resolution of the international debt problem. By expanding exports, the debtor nations can earn the foreign exchange needed to service the outstanding debt. An increase in exports also makes a country's loans more secure by reducing the ratio of annual debt service to export earnings. Moreover, an increase in exports is compatible with raising productivity and fostering economic growth. Experience around the world shows that a strategy of permitting an expansion of exports is far more conducive to economic growth than a policy of import substitution.

The major debtor nations have the capability of expanding exports enough to reduce the relative size of their international debt service to a comfortable level. Brazil, for example, has an annual international interest bill that is now equal to about four percent of its GNP and annual exports that are about ten percent of GNP. Brazil clearly has the resoures, the manpower and the technical ability to increase its export share of GNP by an amount that is at least as large as its current interest bill.

A rising level of exports from the debtor nations requires not only a continuation of economic growth in the industrial nations of the world but also a policy of keeping the markets of the industrial countries open to the products of the developing nations. Of course, an expansion of exports from the LDCs does not mean an equally large decline in the trade balance of the industrial countries because the LDCs would use most of their increased export earnings to purchase an increased volume of imports.

It obviously takes time for the debtor nations to develop export industries and expand the level of exports. The rescheduling arrangements that the commercial banks and the creditor governments have made under the guidance of the International Monetary Fund are providing that needed time for adjsutment. It is important that the United States and the other creditor nations permit the banks to continue to provide the debtor countries with time for adjustment as long as they are making serious efforts to increase their exports.

In most of the debtor countries it would be desirable to supplement the rescheduling of debt and the incease of export earnings with an inflow of new equity capital. Direct foreign investment would not only supplement the annual flow of foreign exchange but would also permit increased domestic capital formation and an infusion of technical knowledge and managerial skills. Unfortunately, many of the debtor countries have been unwilling to accept direct foreign investment or have severely restricted the terms on which such investments can be made. The International Monetary Fund might usefully include provisions on foreign equity investment as part of the conditions in its agreeemts with debtor countries. A debtor country's increased willingness to accept foreign direct investment might justify less severe short-term conditions on its balance of trade or its national saving rate.

Concluding Comments

In conclusion I want to say again how important I think it is for this committee to consider the economic aspects of our foreign policy. There is obviously a wide range of important issues that I have not had time to discuss. Our foreign policy is inextricably linked to the economics of oil and agriculture, to our trade policies with both the market economies and the non-market eoconomies among the developing nations, to our economic relations with Eastern Europe and the Soviet Union, and to many other aspects of our economic affairs. I hope that this committee will continue to devote attention to these important issues.

The CHAIRMAN. Thank you very much, Dr. Feldstein.

I would like to mention that the committee is honored this morning by the presence of diplomats from 20 nations who are visiting Washington under the auspices of the International Visitor Program of the U.S. Information Agency.

Those diplomats are here, appropriately, at a time of discussing global problems of money and trade. We welcome each one of you ladies and gentlemen, and we are grateful that you are a part of our hearing this morning.

At this point I would like to call upon Mr. Henry Fowler, partner in Goldman Sachs & Co., in New York, for his testimony. Mr. Fowler.

STATEMENT OF HON. HENRY H. FOWLER, LIMITED PARTNER, GOLDMAN SACHS & CO., NEW YORK, NY

Mr. FOWLER. Thank you, Mr. Chairman.

I too appreciate your invitation to participate, because I have been deeply concerned with the international economic dimensions of American foreign policy, both as a public servant, the Secretary of the Treasury, and as a private citizen.

I too, like Dr. Feldstein, will try to stay close to your time schedule by omitting substantial portions of the text of my statement. Therefore I ask that the entire statement be included as part of the record.

The CHAIRMAN. It is so ordered, and that will be true of each of the four statements. They will be printed in full.

Mr. FOWLER. The first topic I will discuss is America's role in a global economy. I would like to give a little bit of an overlook at that role, because I think it is highly significant for the present as well as for the future to look back at what has happened since World War II.

America's role in the global economy cannot be measured alone in dry statistics or material terms, and I do mention a few of the hallmarks statistically, but I will omit that from the reading. America's role in a global economy is better appraised by the intangible concerns for our national interest that were paramount in the minds of the formulators of our modern foreign economic policy in the early postwar period.

That goal was well summarized in the words of Dean Acheson: "To help shape the kind of world in which freedom can endure and prosper." To that end, the United States, working with like-minded democratic societies in the postwar period, sought to create an effective intergovernmental multilateral framework of institutions for consistent international economic cooperation. That framework was designed to provide and maintain an environment for men and women of the participating nations to contribute to and share in a growing global prosperity, based on peace, freedom, and opportunity for the individual.

World War II had shattered the inadequate and somewhat primitive framework of the pre-1939 international economy, and the new multilateral institutional framework developed for international cooperation with the leadership of the United States quickly proved to be an unprecedented success. The International Monetary Fund [IMF], the International Bank for Reconstruction and Development [IBRD], the World Bank, the so-called Bretton Woods institutions, supplemented by the General Agreements on Tariffs and Trade [GATT], the Organization for Economic Cooperation and Development [OECD], the Group of Ten, and regional bodies such as the European Economic Community [EEC], the Inter-American Development Bank [IADB], and the Asian Development Bank [ADB], became key elements in a rapidly expanding global economy.

For nearly a quarter of a century, national governments and the private citizenry of the participating governments found an environment for steadily sustained noninflationary economic growth. International trade, capital movements, both governmental and private, and foreign direct investment expanded on a scale unprecedented in human history, contributing a dynamic quality to global economic growth with a considerable measure of financial stability.

Greater economic freedom and opportunity and more jobs, an improving standard of living, and relatively peaceful and fruitful economic relationships were brought to the peoples of many nations.

In the 1970's, this success story for the global economy and its multilateral institutional structure ran into rough and troubled waters. I need not recall to you the events of the last decade particularly, which climaxed in the early eighties with the worst global economic decline since the 1930's.

Persistent inflationary pressures, low productivity, mounting unemployment at double digit levels, throughout Western Europe and North America, massive payments imbalances, and an international debt crisis for much of the Third World have marked the early eighties.

While there has been, as my colleagues here have indicated, some recovery, particularly in the United States, in the last 2 years, much remains to be done in the months and years just ahead to sustain that recovery and have it spread.

Moreover, the policy decisions that are involved in maintaining and sustaining that recovery have short-term and longer term dimensions, and we will mention the shorter term issues, some of which have been covered by previous commentators here.

But I do want to at least note the longer term prospect. The impediments to global economic growth of the 1950's are different from the impediments we see today, and I daresay the impediments in 2005 will be somewhat different from the ones that we are currently encountering.

And therefore it is important to think and follow the practice of trying not only to remove those impediments that stand in the way or in front of economic growth and financial stability, but also to try to adapt or modify or change the operations of this multinational institutional framework created by national governments to deal with the changing economic problems.

And I mention some of the other elements that must be involved in that process. And I also note in my statement the endorsement of President Reagan at the annual meeting of the IMF and the World Bank last September, in which—and I quote the reference in which he says: "The IMF and the World Bank have been the cornerstones of the international monetary system, and the United

States remains honored to be one of the founding fathers of both organizations."

And I quote further: "Besides their enormous contributions to individual freedom, prosperity, and initiative, these multilateral organizations are effectively handling even greater responsibilities as a technological revolution ushers in an increasing velocity of human transactions and greater global economic interdependence."

Then Secretary of the Treasury Donald Regan's statement at that annual meeting also noted: "The IMF and the World Bank are even more central to the global economy of the 1980's than they were when they were first created." And Secretary Regan outlined some suggestions and proposals for dialog and/or negotiation looking to the longer term improvement and adaptation of these institutions to the changing times.

Both President Reagan and Secretary Regan were in the tradition of their predecessors, going back to the World War II aftermath and those holding the offices of Secretary of State in an unbroken line, and I will omit the recounting of the contributions of each administration and each President and each Secretary of the Treasury to this process of evolution and adaptation of this institutional framework, which I think is terribly important.

Against this background, just let me say that it is only in the troubled times of the last few years that there has been a serious erosion of congressional support for these institutions, dramatized in the struggle to deal with the international debt crisis. That is, a support of this multilateral institutional framework.

You will recall that 2 years ago the House of Representatives came within seven votes of defeating a quota increase for the IMF at a time when the international economic system was precariously balanced on the IMF ability to cope with the international debt crisis. In my view, this is symptomatic of a lack of widespread understanding in the Congress of the eighties and the public at large of the role of the IMF and the World Bank.

I would like to submit as exhibit A, which is attached to my text, a supplementary statement which is an informative piece for the committee about the recent formation in January of this year of the so-called Bretton Woods Committee, consisting of about 200 top business executives and former Government leaders who share a concern about the future and the support from the Congress of these two Bretton Woods institutions.

Now, against this backdrop I would like to refer to the impediments to global growth at present, and then conclude with some comments about how the United States can in my judgment best contribute to stimulating and sustaining global economic growth.

Perceptions in the marketplace are often as important as realities. In view of the word "present" in your query concerning impediments to global economic growth, it would be useful for me to provide the current views of some of those on the firing line, as you heard the views of my colleagues here from the professional economic front.

I refer to senior executives of several hundred leading multinational industrial and financial companies operating in the international marketplace, with whom I met in all-day meetings last week in Frankfurt and London. Meetings at both of these places were under the aegis of the International Management and Development Institute as a part of a continuing dialog between business and government leaders on both sides of the Atlantic. The purpose of this dialog is to discuss what we can do together, that is the nations and the private sectors can do together, to achieve and sustain economic recovery.

We distributed a questionnaire at the outset of both of these meetings to solicit the views of those participating on the contemporary critical issues facing the global economic recovery. And I thought it would be interesting to the committee to see through their eyes what they consider the most important impediments.

The results in Frankfurt were as follows, and that is set forth in detail in exhibit B to my statement. They show that the U.S. Federal budget deficit ranked No. 1; that the value strength of the U.S. dollar ranked No. 2; rising protectionism in the United States and worldwide ranked No. 3; the U.S. balance of trade deficit ranked No. 4—this is in Frankfurt—and Third World debt problems ranked No. 5; and reduction in interest rates ranked No. 6, that is U.S. interest rates.

In London it was a little bit different, but the Federal budget deficit ranked No. 1; the value strength of the dollar ranked No. 2; reduction in U.S. interest rates ranked No. 3; rising protectionism in the United States and worldwide ranked No. 4; and Third World debt problems ranked No. 5. And then there was a new starter: The monetary policy of the Federal Reserve System ranked No. 6.

Well, the revelations in the dialog that followed gave me some clue as to the thinking behind these assessments, and two conclusions I drew from what was said during the 2 days of discussion.

First: It will come as no surprise that the U.S. Federal budget deficit is viewed as big No. 1 impediment to sustaining global economic recovery, just as it is thought to be in the United States.

Second: They discern a very close interrelationship between the Federal budget deficit and the next five most highly rated impediments in the rankings. The U.S. Federal budget deficit is apparently viewed, as I could best gather from the dialogs in Frankfurt and London, as the principal threat to a sustained global economic recovery, but also as an important contributor to each of the other five critical problems; not the sole cause, but an important contributing factor.

Some of the perceptions, reasoning or impressions that were voiced at these meetings and widely reflected by the business and financial sector I have set forth in some detail in the pages that follow in the text of my statement. Because much of it has been said by Dr. Cooper and Dr. Feldstein, I will not take up the time of the committee but leave them for the record.

However, in several respects the analysis that was revealed at these conferences omitted some impediments to growth that I would think deserve very important consideration, particularly at present.

First, the analysis does not address the rather substantial differences between the rate of economic growth during the recent recovery in the United States and Western Europe, and the fact that recoveries in both Western Europe and Japan have been largely export-led. There have been references, too, already this morning to this imbalance in the rate of recovery between the United States on the one hand and Western Europe and to some extent Japan on the other, as being a contributing factor particularly to our balance of trade deficit.

I will omit the reading of that, except to say that a second factor that was omitted in the discussions there that seemed to me to be important is that chronic inflation is still an overhanging threat in many of the industrialized economies, and that its recent reduction in scale from near double digit levels of the seventies to a 4- or 5-percent level may be reversed unless fiscal and monetary discipline are steadily maintained. Only the Federal Republic of Germany and Japan seem to have moved inflation down to what can be properly described as reasonable price stability.

I would like at this point to offer for the record a copy of a recent report of the Committee to Fight Inflation, issued on February 14, and ask that it be made exhibit D to my statement. The press release included identifies the members of the committee, which Dr. Herbert Stein and I serve as the cochairmen. It is a bipartisan group of both former Government officials on Republican and Democratic sides, both on the Hill and in the administration.

The CHAIRMAN. By unanimous consent, it will be included.

Mr. FOWLER. Mr. Chairman, since my time is up I will not go over the conclusions, my own personal conclusions, to your query about how the United States can best contribute to stimulating and sustaining global economic growth. It will come as no surprise that the first proposal is addressed to removing and reducing very substantially, by a quickly designed and generally accepted program the Federal deficit over the next 3 years to balance or closely approaching balance.

I think it has to be done over a 3-year period because to try to do it all at once would be literally impossible and would certainly throw us back, I think, into another recession because of the big fiscal stimulus that that deficit has produced.

But I do think it is fundamental to a solution of not only our own domestic problem, but many of these international economic problems which, in view of the linkages between it and the various factors that are important for us to make a credible start on that prospect.

The second point I will not read, but it has to do with a coordinated program through the multilateral institutional framework for some fiscal and monetary policies and related domestic policies that would be conducive to increased domestic noninflationary growth in Western Europe and to some extent in Japan, growth that is domestic in both its origins and its impact, rather than being purely export-led growth, which is the growth that is most perceptible now.

The third proposal has to do with economic growth in the heavily indebted developing countries, and contains an encouraging statement from the managing director of the IMF, which I quote, having to do with the prospects of what can be achieved in restoring growth in those countries over the next few years if the IMF and those countries hold to the adjustment program that the IMF has worked out with them.

The fourth proposal has to do with the rising tide of protectionism, and that has also been covered here.

And the last one has to do with the value of the dollar.

I conclude with a final proposal that I would hope that our foreign economic policy could include in the period ahead U.S. leadership in the process of trying to adapt this multilateral institutional framework to the new problems that have emerged in the 1970's.

I would think that perhaps the first candidate, although the GATT needs some obvious modification for it to do its job, another promising candidate would be to resume the work of the Committee on Reform of the International Monetary System, the so-called Committee of Twenty, which was cut short somewhat by the OPEC oil price explosion in 1973 and 1974.

The second amendment to the articles of agreement to the IMF left unsettled and unresolved many of the issues pending at that time which are some of the issues that concern us today, namely a misalignment of exchange rates and the excessive volatility of exchange rates.

That concludes my statement, sir.

[Mr. Fowler's prepared statement follows:]

REMARKS OF HENRY H. FOWLER
FEBRUARY 28, 1985
BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE

My name is Henry H. Fowler. I am now a Limited Partner of Goldman Sachs & Co., having recently retired from active participation in the firm's investment banking business. I reside in Alexandria, Virginia.

I appreciate your invitation to participate in your examination of the international economic dimensions of American foreign policy, having been deeply concerned with it for nearly a quarter century both as a public servant and a private citizen.

My first hand experience of some relevancy arises out of seven years in the U.S. Treasury, as the Undersecretary from early 1961 to mid 1964 and as Secretary from April 1965 through 1968, followed by sixteen years as Chairman of Goldman Sachs International Corporation, concerned primarily with the firm's international activities in Western Europe and the Far East.

In addition to these professional responsibilities, I have been actively interested as a private citizen in the interrelation between U.S. foreign policy and the international economy, serving at various times since 1969 as Chairman of the Atlantic Council of the United States and a Governor of the Atlantic Institute for International Affairs, Chairman of the Executive Committee of the Japan Society, a Councilor to the Conference Board, Chairman of the U.S. Treasury Advisory Committee on International Monetary Reform since 1973, and co-Chairman of the Fowler-McCracken Commission since 1981, a non-partisan international effort directed toward "Inspiring Government-Business Cooperation in the Conduct of International Economic

Policy" sponsored by the International Management and Development Institute.

I have attended with fair regularity the annual meetings of the International Monetary Fund and the World Bank, the Interamerican Development Bank, and the Asian Development Bank, maintaining an active unofficial interest in these organizations, growing out of my service as the U.S. Governor in each of them as Secretary of the Treasury.

In your current overview of "The Future of American Foreign Policy" you ask for an examination of "America's role in a global economy, focussing particular attention on how we can best contribute to stimulating and sustaining global economic growth and on what you view as the most serious impediments to such growth at present."

I. America's Role in a Global Economy

America's role in a global economy cannot be measured alone in dry statistics or material terms.

Its share of gross world product was roughly 25 per cent in 1933 having tripled its gross national product per head in real terms since 1950. Its exports were about 22 per cent of gross world exports; its imports were about 35 per cent. The foreign direct investments of its corporations amount to about $ 226 billion. Estimates are that over 20 per cent of the output of U.S. manufacturing industry depends directly on export markets and two out of every five producing acres of farmland find export markets.

America's role in a global economy is better appraised by the intagible concerns for our national interest that were paramount in the minds of the formulators of our modern foreign economic policy in the early post World War II era.

The goal was well summarized in the words of Dean Acheson: to help shape "the kind of world in which freedom can endure and prosper."

To that end the United States, working with like minded democratic societies, in the post war period sought to create an effective intergovernmental multilateral institutional framework for consistent international economic cooperation. That framework was designed to provide and maintain an environment for men and women of the participating nations to contribute to and share in a growing global prosperity based on peace, freedom and opportunity for the individual.

World War II had shattered the inadequate, somewhat primitive framework of the pre-1939 international economy. It had failed in much of its essential purpose in the global economic collapse of the early thirties, marked by the rise of autarchy, totalitarianism and World War II. 1945 saw the movement across national borders of trade, capital and private foreign direct investment in a shambles.

The new multinational, institutional framework developed for international cooperation with the leadership of the United States was an unprecedented success. The International Monetary Fund (IMF), the International Bank for Reconstruction and Development (World Bank), the so-called Bretton Woods institutions, supplemented by the General Agreements on Tariffs & Trade (GATT) and the Organization for Economic Cooperation and Development (OECD), the Group of Ten, and regional bodies such as the European Economic Community, the InterAmerican Development Bank and the Asian Development Bank became key elements in the rapidly expanding global economy.

For nearly a quarter century many participating national governments and their private citizenry found an environment for steady sustained non-inflationary economic growth. International trade, capital movements (governmental and private), and foreign direct investment expanded on a scale unprecedented in human history, contributing a dynamic quality to global economic growth with a considerable measure of financial stability.

Greater economic freedom and opportunity, more jobs, an improving standard of living, and relatively peaceful and fruitful economic relationships were brought to the peoples of many nations.

In the nineteen seventies this success story for the global economy and its multilateral institutional structure ran into rough and troubled waters. Waves of worldwide inflation, sometimes of double digit dimensions, abetted but not entirely caused by the two oil price explosions, brought on an era of stagflation intermixed with periods of recession. This economic deterioration climaxed ultimately in the early eighties with the worst global economic decline since the early thirties. Persistent inflationary pressures, low productivity, mounting unemployment into double digit levels throughout Western Europe and North America, massive payments imbalances and an international debt crisis for much of the Third World marked the early eighties.

While there has been some recovery, particularly in the United States in the last two years, much remains to be done in the months and years just ahead to sustain that recovery and have it spread throughout the global economy.

Much needs to be done by a concertation of national economic policies to restore the stability of the global economy and set it upon a path of healthy non-inflationary global growth, reasonable international equilibrium in balances of trade and current account and better aligned exchange rates. A number of impediments stand in the way like icebergs threatening an unwary or undisciplined ship.

Today, this global economy is confronted by some critical issues that have arisen in acute form, mostly in the last decade. Wise, timely and effective decisions of foreign and related domestic economic policy by the United States and its partners are necessary.

This policy decison making has both short term and longer term dimensions.

The shorter term issues we will discuss shortly. They will involve effective utilization of the existing multinational institutional framework -- the IMF, World Bank and OECD particularly. The economic summit meetings by the Chiefs of State of the major industrialized democracies can play an increasingly important role, particularly as solutions may depend upon domestic fiscal and monetary action, as well as wise foreign economic policies. The Interim and Development Committee of Governors (Committee of Twenty) of the IMF and World Bank which includes Governors representative of both the industrialized democracies and the developing countries has an important role to play.

But, there are longer term issues facing the global economy arising out of the changing times through which we inevitably move.

The impediments to global economic growth and financial stability that faced a war-ravaged world in the first post-war decade are not the same as those confronting the global economy in the nineteen eighties. In all probability, some of the special problems that will emerge in the twenty-first century may differ somewhat from those we face today.

But the purusuit of a healthy, stable global economy in 1950, 1985 and 2005 are likely to have several elements in common.

First, the removal of serious impediments to economic growth and financial stability will entail an adaptation, modification or change in the operations of the multinational institutional framework created by national governments to deal cooperatively with economic problems.

Second, those adaptations, modifications or changes must be conducive to and congenial with the expansion of foreign trade, international capital movements and foreign direct investment.

Third, freedom of opportunity for the individual, with adequate incentives to work, save and invest, must be provided because they have proved essential to global economic growth as well as healthy national economies.

At the Annual Meeting of the IMF and the World Bank last September President Reagan made clear his support for these institutions. He said:

> "As we go forward, we will support our two great institutions, the IMF and the World Bank, which have been the cornerstones of the international monetary systems since World War II. The United States remains honored to be one of the "founding

> fathers" of both organizations. Besides their enormous contributions to individual freedom, prosperity, and initiative, these multilateral organizations are effectively handling even greater responsibilities as the technological revolution ushers in an increasing velocity of human transactions and greater global economic interdependence."

In the then Secretary of the Treasury Donald Regan's statement at this recent Annual Meeting of the IMF and World Bank, he stated:

> "The IMF and the World Bank are even more central to the global economy of the 1980s than they were when they were first created."

In the course of his commentary, Secretary Regan outlined a series of suggestions or proposals for dialogue and/or negotiation, looking to long term improvement and/or adaptation of these institutions to changing times.

Both President Reagan and the then Secretary of the Treasury Regan were in the tradition of their predecessors and those holding the office of Secretaries of State in an unbroken line stretching back through every Administration since World War II in treating these institutions as the "cornerstones of the international monetary system", "central to the global economy". It is also in the great tradition of post war U.S. foreign economic policy to review the functioning of these organizations and seek from time to time, and step by step, to improve them and adapt them to changing times.

If there is a foreign policy that has exemplified bipartisanship and consistency, regardless of the political party in charge of the Executive Branch or the Congress, it is this foreign economic policy. A brief historical tour will illustrate this proposition.

Under President Truman and Secretary Snyder the two Bretton Woods organizations were brought from Articles of Agreement to living reality.

Under President Eisenhower and Secretary Anderson, the International Development Association (IDA) was established in the late fifties to provide a "soft" loan window at the World Bank for the member countries who could not afford the full going rate and terms of the Bank's "hard" loan window for their essential and pressing development needs. Also, the International Finance Corporation (IFC) was established in 1956 as an affiliated organization to supplement the activities of the World Bank by providing the type of financing and investment expertise particularly suited to attracting, and lending confidence to private sector investors in developing countries. Also they initiated the organization of the InterAmerican Development Bank and obtained authorization for the United States to become a member of the OECD (Organization for Economic Cooperation and Development).

Under President Kennedy and Secretary Dillon, the General Agreements to Borrow was negotiated to enlarge the resources available to the IMF under special circumstances. Also a thorough-going multilateral examination of the case for the role of gold and the official reserves of gold, dollars and pounds was initiated.

It was my privilege, with President Johnson's authorization, to undertake and obtain agreement to the First Amendment of the IMF Articles of Agreement for the establishment of a new reserve asset, the SDR or Special Drawing Rights. President Johnson himself launched another initiative, which was successfully negotiated by then Undersecretary, later, Secretary Barr and Mr. Eugene Black, a former President of the World Bank, to become the Asian Development Bank.

Under Presidents Nixon and Ford and Secretaries Connolly and Shultz, the Second Amendment of the IMF Articles of Agreement was negotiated and adopted. It made several changes, the most notable of which was to move the international monetary system from one of fixed exchange rates to one in which each member country could allow the exchange rate of its currency to "float" or be tied to a currency or currencies of its choice.

Under President Ford and Carter and Reagan and Secretaries Simon, Blumenthal, Miller and Regan, the practice of economic summitry was instituted and developed as a useful annual review of foreign economic and some related domestic policies at the chief of state level of seven of the major industrialized democracies.

It is also important to note that along this foreign policy path there has been a remarkable degree of cooperation between successive Administrations and the Congress, particularly at the leadership level, and on both sides of the aisles.

There has been a sharing of bipartisan concern in Congress for making and keeping effective the machinery of international cooperation, going back to the precedent set by the late Senator Vandenberg and his colleagues. For the most part there has been a durability and consistency to this collaboration.

Only in the recently troubled times has there been a serious erosion of Congressional support, dramatized in the struggle to cope with the international debt crisis. You will recall that two years ago, the House of Representatives came within seven votes of defeating a quota increase for the IMF at a time when the international economic system was very precariously balanced on its ability to cope with the international debt crisis. In my view, this is symptomatic of a lack of widespread understanding in the Congress of the Eighties and the public at large of the role of the IMF and World Bank.

Against this background I seize this opportunity to acquaint your Committee with a new private sector effort to be of assistance. I am submitting as Exhibit A to my full statement, a Supplementary Statement which is a brief informative piece about the recent formation in January of this year of the Bretton Woods Committee, consisting of nearly 200 top business executives, and former government leaders, who share a concern abut the future of the Bretton Woods institutions. I invite your attention to this document for future reference as you consider from time to time America's role in the world economy.

I am participating in this activity because of a firm conviction that the national interest of the United States and its people now, and for generations to come will be well served by U.S. efforts to play its appropriate role in maintaining and making ever more effective the multilateral, institutional framework for international economic cooperation that has developed since the end of World War II.

A high order of leadership, the practice of unfailing bipartisanship in these endeavors, a close cooperation between Congress and the Executive Branch, and an unremitting consistency of purpose and effort will be necessary, just as in the glory days of the U.S. post World War II foreign economic policy.

Against this backdrop I will first discuss impediments to global growth at present (See Part II) and offer some conclusions about how the United States can best contribute to stimulating and sustaining global economic growth (See Part III).

II. Impediments To Global Growth at Present

Perceptions in the marketplace are often as important as realities.

In view of the word "present" in your query concerning impediments to global economic growth, it will be useful for me to provide the current views of some of those on the "firing line." I refer to senior executives of several hundred leading multinational industrial and financial companies operating in the international marketplace with whom I met in all day meetings last week in Frankfurt and London.

Meetings at both places were held under the aegis of the International Management and Development Institute and its Fowler-McCracken Commission as part of a continuing dialogue between business and government leaders on both sides of the Atlantic. The purpose of these dialogues is to discuss what we can do together "to achieve and sustain economic recovery throughout the year ahead and the remainder of the century."

A questionnaire was distributed at the outset of the meetings to solicit views of each participant on the contemporary critical issues facing the current global recovery. It listed some nineteen "Most Critical Issues in 1985-86," inviting the participants to identify each one as "very important", "somewhat important" and "not important".

The results in Frankfurt (See Exhibit B) showed the U.S. Federal Budget Deficit ranked No. 1; the Value-Strength of the U.S. Dollar ranked No. 2; Rising Protectionism in the U.S. and Worldwide ranked No. 3; the U.S. balance of trade deficit ranked No. 4; Third World Debt Problems ranked No. 5; and Reduction In U.S. Interest Rates ranked No. 6.

The results in London (See Exhibit C) showed the U.S. Federal Budget Deficit ranked No. 1; the Value/Strength of the U.S. Dollar ranked No. 2; Reduction in U.S. Interest Rates ranked No. 3; Rising Protectionism in the U.S. and Worldwide ranked No. 4; Third World Debt Problems ranked No. 5, and Monetary Policy of the Federal Reserve System ranked No. 6.

There are several highly interesting revelations in these rankings about the mindsets in the private business and financial sectors in Western Europe towards impediments to sustaining the global recovery.

First, it will come as no surprise that the U.S. Federal Budget Deficit is viewed as Big Number One impediment to sustained global economic recovery just as it is thought to be in the United States for sustained domestic recovery and long term growth.

Second, there is a close interrelationship between the U.S. Federal Budget Deficit, Big Number One, and the next five most highly rated impediments in the rankings.

The U.S. Federal Budget Deficit is apparently viewed, as I could best gather from the dialogues in Frankfurt and London, as the principal threat to a sustained global economic recovery but also as an important contributor to each of the other five critical problems -- not the sole cause, perhaps, but a very important related factor.

Some of the perceptions, reasoning or impressions, voiced at these meetings and widely reflected in Western Europe, runs along the following lines.

The U.S. Federal Budget Deficit, at its present levels, and the years in the immediate past, and foreseen for years to come, however currently stimulative of the U.S. economy, is badly distorting the normal functioning of the international monetary system through its side effects.

It induces high interest rates in the United States by causing the U.S. Treasury to hit constantly U.S. money markets at all maturity ranges for nearly $200 billion annually. These budget deficit levels are far in excess of those normally experienced in the U.S., either in nominal figures or as a percentage of gross national product or national savings. The resulting interest rates in real terms (the spread between the inflation rate and nominal interest rates) remain at historically high levels even though in nominal terms they have receded from their highs in the early Eighties.

These high "real" interest rates in the U.S. have two effects that are feared for their impact on sustained economic growth inside and outside the U.S. They attract foreign flows for investment in the U.S., estimated at $100 billion in 1984, with increasing repatriation of U.S. capital abroad.

This importation of huge amounts of capital by a nation that has been a consistent exporter of capital in recent decades if viewed as abnormal and a threat, present or potential, to economic growth outside the U.S.

It is viewed as a threat to prospects for increasing levels of investment for healthy job creating growth in Europe and the Third World.

Moreover, the need of Western Europe to minimize the extraordinary depreciaton of its currencies in their relationship to the dollar to minimize imported inflation from imported goods priced in dollars keeps European interest rates up to levels that may retard the modest European recovery now somewhat underway. The fact that unlike the U.S. tax systems, European tax systems do not permit the deductibility of interest adds to the impact of high interest rates on investment.

Rightly or wrongly, the fear exists in Europe that the U.S. Budget Deficit will lead to either a shortage of capital or unduly high cost of capital for Europe and the Third World.

Through its impact on U.S. "real" interest rates, the U.S. Budget Deficit's indirect creation of a huge foreign investor demand for dollars, to invest in U.S. government sponsored and high grade corporate securities, plays a role in the increasingly high value of the dollar. At least as important a source of capital inflow has been the continued gathering of deposits abroad by U.S. banks and their re-lending of those funds in the U.S., in contrast to the more normal pattern of increasing loans to foreign borrowers.

This increase in the value of the dollar since late 1980 is widely believed in the U.S. and abroad to have contributed to a marked decline in the competitiveness of U.S. products in both export and domestic markets against foreign products.

Significant sectors of U.S. manufactured goods and farm products have suffered badly as the U.S. balance of trade has moved to a $123.6 billion dollar deficit in 1984 from a deficit of $36.4 billion in 1980.

It is recognized that there are other contributing factors leading to this increasing balance of trade deficit as the recently issued Report of the President's Commission on Industrial Competitiveness sets forth. However, it is the advancing dollar in the foreign exchange markets that hits the news week after week and is being increasingly blamed by those losing markets to foreign competitors. The result is a highly observable rising protectionist sentiment in the farm belt and in many manufacturing sectors -- particularly in mid-America. Should the protectionist tide prevail as the answer to the increasingly strong value of the dollar, there is little doubt abroad that it would provoke retaliation, risking a deterioration of our global trading system that would have disastrous consequences for long term global growth.

Also there is a persistent stress on the impact of high interest rates, thought to be induced by the U.S. Budget Deficit on the international debt problems of the Third World nations who must pay much of their debt servicing costs at floating rate levels.

Finally, there are worries about the unbalanced mix of the huge fiscal stimulus of the Federal Budget deficit and the policy of monetary restraint necessarily pursued by the Federal Reserve System in the face of that highly stimulative fiscal policy. Foreigners, as well as people in the United States and the Congress, fear that some day there may be an end of the Fed's "walking the tight rope" act between a risk of a sharp upward inflationary thrust with its interest rate impact leading to yet another recession or a risk of excessive rigidity in Federal Reserve policy causing termination of U.S. recovery into another recession. This happened twice in the nineteen seventies.

This fear is fed by the fact that Germany, Japan, the United Kingdom and a number of smaller European countries have been following an opposite policy of making considerable effort to reduce their structural budget deficits because of their worry about the medium or long term consequences.

In general I would agree with the foregoing analysis of the most important impediments to global economic growth at present, as revealed in the perceptions of a sampling of the private sector in Western Europe. I doubt that there would be much difference in the perceptions of a U.S. private sector group engaged in the mainstream of international business and finance.

However, in several respects the analysis is inadequate because, in my judgment, it omits some impediments to growth that deserve ranking as very important at present. Moreover, they have important relationships to the global picture of financial instability of the recent past and the current gross imbalances that characterize the international monetary picture, which are destructive of the confidence that begets global investment, initiative and growth.

First, the analysis does not address the rather substantial differential between the rate of economic growth during the recent recovery in the United States and Western Europe and the fact that the recoveries in both Western Europe and Japan have been largely export led.

There is no way for the industrial countries of the West and Japan (the OECD group) to both achieve and sustain a healthy and stable rate of non-inflationary growth during the remainder of the 1980s unless:

(a) Fiscal policy becomes somewhat more stimulative in Western Europe to its domestic economies and a stern effort is undertaken to restore some structural flexibilities within those national economies. (For an interesting bill of particulars from a knowledgeable European, I would refer you to the notable address of Managing Director deLarosiere of the IMF on November 29, 1984.)

(b) The Japanese economy shifts its growth pattern to rely more on rising domestic demand rather than depend mainly on exports.

Second, the analysis omits inclusion of chronic inflation still overhanging many of the industrialized economies and the threat that its recent reduction in scale from the near double digit levels of the seventies to a 4 to 5 per cent level may be reversed unless fiscal and monetary discipline are steadily maintained. Only the Federal Republic of Germany and Japan seem to have moved inflation down to what could be properly described as reasonable price stability.

To illustrate this global problem as it pertains to the United States I offer for your record a copy of the recent Report of the Committee to Fight Inflation, issued on February 14, 1985 and ask that it be made Exhibit D, along with the Press Release identifying the members of the Committee, which Dr. Herbert Stein and I serve as co-Chairmen.

III. Conclusions - How the United States Can Best Contribute To Stimulating and Sustaining Global Economic Growth

In your letter of invitation to appear, Mr. Chairman, you asked "how we can best contribute to stimulating and sustaining global economic growth."

My answers, growing out of the previous analysis of "America's Role in a Global Economy" (Part I) and "Impediments to Global Growth at Present" (Part II) will be relatively brief and somewhat general.

They must be general because the proposals must be filled out in detail through the processes of negotiation. These negotiations may be between the Houses of Congress, and the Congress and Administration, and in many instances between the United States and other nations through the multilateral institutional framework described in Part I, supplemented by bilateral diplomacy.

1. The first proposal is addressed to the most important impediment to sustaining economic growth in the United States -- the federal budget deficit.

Sustaining economic growth in the U.S. is the underpinning of any program for global growth. The federal government, with the leadership of the President and the action of the Congress, should within the next seven months, make a credible commitment to a budgetary program that promises to bring the federal budget deficit to or close to balance over a period of three years by the end of the fiscal year 1988.

That program, including a substantial reduction for fiscal 1986 in excess of $50 billion must look beyond that year and include measures that give reasonable assurance that during the two following fiscal years the budget deficit will be reduced to somewhere between zero and the last remaining $50 billion of the deficit.

As an English business leader recently said to me: "We are more interested in seeing how you get to the last $50 billion." In other words, the time for "down payments" is running out. Both people and markets want to see the whole program.

The program should be spaced over a three year span. That should minimize the risk of a sudden, peremptory withdrawal of the tremendous fiscal stimulus from the existing deficit. It will also give monetary policy an opportunity to take advantage in orderly fashion of a better balance of fiscal and monetary restraint to encourage lower interest rates without risking an inflationary surge.

I will not lay out any specific prescription for the internal make-up of this budget deficit reduction program because the important point of emphasis is that it be accomplished rather than the exact make-up and dimensions of the mix.

However, since I was a founding member of the Bipartisan Budget Appeal with four former Secretaries of the Treasury (Dillon, Connolly, Simon and Blumenthal) and former Secretary of Commerce Peterson and our particular formula has been appearing and reappearing in the public press since May 1982, there is no secret about the kind of program that appeals to me.

In addition to restoring a sense of financial stability to U.S. fiscal policy, the announcement and orderly execution of this budget reduction program will be a key first step toward progress in removing the other impediments that have been analyzed in Part II.

2. The second proposal has to do with stimulating the global economic recovery which is not yet well spread beyond North America.

The United States should urge,through the multilateral, institutional framework, decribed in Part I, the adoption by the other industrialized nations, except Canada, of fiscal and monetary policies and related domestic policies that would be conducive to increased domestic non-inflationary growth at a healthy job producing rate.

These policies should be particularly addressed to a worldwide lowering of interest rates and the recovery of business fixed investment which is central and basic to sustainable expansion. Average long-term interest rates remain well above the current rates of inflation in most of the industrialized nations and moreover, the spread over inflation, meaning "real" interest rates, is substantially higher than in the last two or three recoveries.

Action by the United States on its federal budget deficit reduction program will be basic to this international effort.

And as Mr. deLaroserie, Managing Director of the IMF, would remind us:

> "Uncertainties about the future course of inflation still remain. The prospective trend of prices over the next couple of years depends on policies that are not in all cases clearly established and

> may yield to political pressures." (See American Enterprise Institute Studies In Economic Policy, 1984, page 30).

An achievement of meaningful progress along the lines of this second proposal would also help in a substantial way to reduce the rising deficit in the U.S. balance of trade and deficit on current account. It should also help reduce the spread between the major currencies and the dollar.

3. The third proposal is directed toward both sustaining and stimulating global growth by enhancing, over the medium term (the remaining eighties) economic growth of the heavily indebted developing nations and the ultimate solution of the international debt problem by the reduction of their external debt to exports of goods and services.

That proposal is simply that the United States continue to do, as it has been doing, strongly support the IMF in its efforts to assure a continued observance of the adjustment programs that it has successfully hammered out.

According to Manager Director deLarosiere:

> "The latest medium-term projections undertaken by the Fund staff suggest that by 1990, the ratio of external debt to exports of goods and services for the seven most heavily indebted countries, taken together, could fall by two-fifths, while economic growth could increase to about 5 per cent a year over the second half of the decade."

4. The fourth proposal has to do with the rising tide of protectionism that threatens to overturn the progress of the last forty years toward freer and fairer trading markets.

It is timely that preparations, discussed for sometime, for another full scale round of negotiations under the aegis of the GATT (General Agreements on Tariffs and Trade) be completed, and the negotiating process be formally put underway. In addition to the distinctive substantive issues of trade in agriculture, services, and an expanding range of non-tariff barriers which threaten to replace the role of high tariffs several decades ago, there is also a broad question of updating the machinery and organization of the GATT.

There are many technical proposals available from those who have had long and ofttimes frustrating experiences in this field.

At least the substantive issues that bear upon the problems immediately facing the international trading community can be tackled to help avert the swelling tide of protectionist threats. While many of these issues can be somewhat bilateral in origin, they should ultimately be resolved in a multilateral context.

5. The last proposal transcends most of the impediments, confronting the global economy and sustaining its recent recovery, save one -- the value of the dollar. It is addressed to the longer term concerns -- the adaptation, modification or change in the operations of the multinational, institutional framework created by national governments to deal cooperatively with economic problems.

I would propose that the time has come for the United States to again take the leadership in updating some of the existing organizations (IMF, World Bank, GATT and OECD in particular) to deal more effectively with the problems that have arisen in the nineteen seventies and early eighties.

Private organizations and scholars abound who have produced thoughtful works concerning this subject and the unsolved issues that the existing framework has not satisfactorily resolved. Various options for improvement have been put forward.

I have alluded to some of the inadequacies in passing -- the issues of an adequate system for multilateral trading on a free and fair basis -- the value of the dollar and the misalignment and excessive volatility of exchange rates. There are many others such as those I described on pages 12 and 13 of my testimony before this Committee in January 1983 in connection with the international debt crisis.

But, for example, to my knowledge, there has been no intensive multilateral re-examination of the workings of the international monetary system since the famous and worthy efforts of the Committee on Reform of the International Monetary System and Related Issues (Committee of Twenty) in 1973-74. Those efforts were necessarily cut somewhat short by the OPEC oil price explosion of that time. The Second Amendment of the Articles of Agreement of the IMF left unsettled and unresolved many of the issues pending at that time.

Maybe a good place to start on this process would be to conduct a similar re-examination to ascertain whether the present arrangements are adequate or should be modified or adapted to the issues that have emerged in the intervening years.

EXHIBIT A

SUPPLEMENTARY STATEMENT OF
HENRY H. FOWLER
TO THE
SENATE FOREIGN RELATIONS COMMITTEE

FEBRUARY 28, 1985

Mr. Chairman, and Members of this distinguished Committee. Thank you for including me in this hearing.

I would like to make a few remarks about the state of the international economic system and focus some specific attention on two institutions that play a critical role in preserving stability within it.

As you know, the health of the international financial system continues to be uncertain. While the threat of extensive Latin American defaults seems to have been averted, the system is still at great risk and economic growth remains low. No quick or easy solutions are visible on the horizon.

It is not only developing countries that feel the pressure. In an economically interdependent world, the United States suffers substantial economic injury when developing country markets shrink or are closed. The net flow of capital to developing countries shows signs of declining again this year. This not only creates instability and breeds unrest in borrowing countries, but in the end directly reduces U.S. exports, jobs, and profits.

The United States has a strong interest in seeing developing countries grow at a rate faster than what we have seen recently. Increased capital flows, along with more effective domestic adjustment policies will be needed if the situation is not to worsen. Continuing to rely solely on a strategy of damage-limitation may result in increased economic and social turmoil, further narrowing our export markets and risking far more serious consequences.

The World Bank and the International Monetary Fund (IMF) are the two institutions around which solutions must be built. However, for reasons which have little to do with the effectiveness of these institutions, their continued support in the United States is in danger.

President Reagan made clear his support for these institutions in a speech last year to their annual meeting. He said:

> As we go forward, we will support our two great institutions, the IMF and World Bank, which have been the cornerstones of the international economic and monetary systems since World War II. The United States remains honored to be one of the "founding fathers" of both organizations. Besides their enormous contributions to individual freedom, prosperity, and initiative, these multilateral organizations are effectively handling even greater responsibilities as the technological revolution ushers in an increasing velocity of human transactions and greater global economic interdependence.

About the World Bank he said:

> Last year the World Bank committed over $15 billion to supplement the efforts of developing member countries to strengthen their economies. In addition to its proven expertise as an investment project lender, we value highly the bank's ability to provide helpful policy guidance and technical assistance and to act as a catalyst in encouraging private enterprise and investment capital.

> We are committed to providing the agreed-upon level of U.S. contributions to the IBRD Selective Capital Increase, the Seventh Replenishment of IDA and the capital increase of the IFC.

About the IMF he said:

> The IMF has always had a central role in assisting members facing serious balance of payments problems, and it has assumed leadership in helping debtor countries design economic adjustment programs which seek to restore economic and financial balance and creditworthiness. For our part, considerable effort went into negotiating and obtaining the necessary legislative concurrence for United States participation in the quota increase which provided resources for the Fund to deal with this difficult problem.

As members of the Committee well know, the President's strong endorsement of these institutions and his recognition of their need for increased funds, provides no assurance that the Congress will ultimately approve new money requests for them. The House of Representatives two years ago, came within seven votes of defeating a quota increase for the IMF at a time when the international economic system was very precariously balanced. In my view, this is symptomatic of a lack of widespread understanding in the Congress and the public at large of the role of the IMF and the World Bank.

I do not need to preach to this choir about the importance of these institutions. Traditionally, the world has looked to the World Bank and the regional development banks for leadership in addressing the problems of development and balance of payments financing.

The economic policy prescriptions of the IMF and the temporary financing that it provides have helped many countries to regain their economic health. In the current debt crisis, the IMF has been in the forefront of every international rescue effort, providing transitional financing and coordinating the efforts of commercial lenders.

The World Bank's efforts to promote long-term growth have complemented these crisis efforts of the IMF. Many borrowers in the developing world face low and falling incomes - particularly in Sub-Saharan Africa, poor Asian countries such as Bangladesh, and major debtors in Latin America. Without the economic restructuring and growth that the World Bank loans help make possible, the international debt problem will be even more difficult to resolve.

In an effort to increase public understanding of these institutions, a new group has been formed --- called the Bretton Woods Committee. The group consists of nearly 200 top U.S. business executives, and former government leaders who share a concern for the future of the Bretton Woods institutions. Former Presidents Ford and Carter are our Honorary Co-Chairmen, Ambassador Henry Owen chairs the Executive Committee; and Charls Walker and I are the group's Co-Chairmen. James Orr is our executive director.

The committee will do two things. It will study the important questions about the future of the Bank and Fund and share its conclusions with the Congress, the administration, the management of these institutions and the public. Among the questions we will be looking at are the following: Should the Bank substantially expand its lending as part of a productive and sustainable flow of capital to the developing countries? How effectively is it using its existing resources? How can it encourage and complement more commercial bank lending? How active will the IMF have to be in the adjustment process? What role can it play in helping to bring about a correction in the current misalignment of exchange rates? How will it raise the resources necessary to achieve these ends?

Our second mission will be to help build a constituency for these institutions by increasing public understanding of their role in the system, through a program of public education.

I should add that the group will not be cheerleaders for whatever proposals the management of the institutions or administrations bring forth. We will remain informed and critical observers of the institutions.

The Committee hopes to maintain close contact with the Congress and this Committee in particular. We want to be of assistance to you in helping examine issues surrounding U.S. participation in the World Bank and the IMF. We hope you will call on us.

EXHIBIT C

London

103 participants
66 responses

IMDI

February 1985 U.S.-European Top Management Roundtables

MOST CRITICAL ISSUES IN 1985-86 AFFECTING CORPORATE COMPETITIVENESS IN THE INTERNATIONAL MARKETPLACE

Today's discussions are part of a continuing dialogue among international government and business leaders on what we can do together to achieve and sustain economic recovery through the year ahead and the remainder of the century. Similar Top Management Roundtables will be convened across Western Europe during 1986. To aid in planning for these policy dialogues, we invite your assessment of the "most critical issues" international government and business leaders must address.

Please rate each of the following issues in terms of its relative importance to you.

	RAW SCORE	Very Important	Somewhat Important	Not Important	No Comment	RA
1. U.S. federal budget deficit	119	56	8	1		1
2. U.S. balance of trade deficit	89	33	26	3		7
3. Third World debt problems	94	37	25	5		5
4. Competitiveness of U.S. and European companies both in the U.S. and international marketplace	80	30	25	5		8
5. Value/strength of U.S. dollar	117	55	9	2		2
6. Removal of export disincentives	17	7	26	23		18
7. Export financing/incentives	10	4	27	25		19
8. Trade in high-technology goods	31	13	24	19		13
9. U.S. regulatory reform (i.e., reducing red tape)	28	9	29	19		15
10. U.S. tax reform (i.e., current "flat tax" proposals)	24	10	25	21		16
11. Strengthening the educational system	30	12	24	18		14
12. Rising protectionism in the U.S. and worldwide	104	45	17	3		4
13. Reduction of U.S. interest rates	107	46	17	2		3
14. Monetary policy of the Federal Reserve System	91	32	29	2		6
15. Employment adjustments/retraining	33	10	29	16		12
16. Future energy policies	56	10	43	7		11
17. Strengthening the industrial/technological base of the Atlantic Alliance	57	17	33	10		10
18. Agricultural competitiveness in the U.S. and world marketplace	20	6	28	20		17
19. Expanding trade and investments between the industrialized and developing worlds	78	24	34	4		9
20. Other:						

( ) I would like to participate in the continuing dialogue of the Fowler-McCracken Commission.

NAME
TITLE
ORGANIZATION
ADDRESS
TELEPHONE TELEX

INTERNATIONAL MANAGEMENT AND DEVELOPMENT INSTITUTE
2600 Virginia Avenue, N.W. • Suite 905 • Washington, D.C. 20037-1906

1/31/85

EXHIBIT B:

IMDI (142 participants) FRANKFURT (47 samples)

February 1985 U.S.-European Top Management Roundtables

MOST CRITICAL ISSUES IN 1985-86 AFFECTING CORPORATE COMPETITIVENESS IN THE INTERNATIONAL MARKETPLACE

Today's discussions are part of a continuing dialogue among international government and business leaders on what we can do together to achieve and sustain economic recovery through the year ahead and the remainder of the century. Similar Top Management Roundtables will be convened across Western Europe during 1986. To aid in planning for these policy dialogues, we invite your assessment of the "most critical issues" international government and business leaders must address.

Please rate each of the following issues in terms of its relative importance to you.

	RAW SCORE	Very Important	Somewhat Important	Not Important	No Comment	RANKING ORDER
1. U.S. federal budget deficit	86	39	8	0		1
2. U.S. balance of trade deficit	68	24	21	1		4
3. Third World debt problems	67	25	19	2		5
4. Competitiveness of U.S. and European companies both in the U.S. and international marketplace	61	19	25	2		7
5. Value/strength of U.S. dollar	81	34	13	0		2
6. Removal of export disincentives	17	7	18	15		15
7. Export financing/incentives	14	7	18	18		16
8. Trade in high-technology goods	36	13	20	10		11
9. U.S. regulatory reform (i.e., reducing red tape)	12	5	13	11		17
10. U.S. tax reform (i.e., current "flat tax" proposals)	27	10	16	9		14
11. Strengthening the educational system	7	4	15	16		18
12. Rising protectionism in the U.S. and worldwide	79	36	8	1		3
13. Reduction of U.S. interest rates	63	22	22	3		6
14. Monetary policy of the Federal Reserve System	60	21	22	4		8
15. Employment adjustments/retraining	28	7	22	8		13
16. Future energy policies	32	2	34	6		12
17. Strengthening the industrial/technological base of the Atlantic Alliance	48	15	22	4		10
18. Agricultural competitiveness in the U.S. and world marketplace	4	4	13	17		19
19. Expanding trade and investments between the industrialized and developing worlds	50	11	30	2		9 } tie
20. Other: Inflation / Threat of inflation	50	19	13	1		9
		+2	+1	-1		

( ) *I would like to participate in the continuing dialogue of the Fowler-McCracken Commission.*

NAME ______________________

TITLE ______________________

ORGANIZATION ______________________

ADDRESS ______________________

TELEPHONE ______________ **TELEX** ______________

INTERNATIONAL MANAGEMENT AND DEVELOPMENT INSTITUTE
2600 Virginia Avenue, N.W. • Suite 905 • Washington, D.C. 20037-1985

1/31/86

American Enterprise Institute for Public Policy Research

PressRelease

1150 Seventeenth Street, N.W., Washington, D.C. 20036

CONTACT: Patrick Ford,
202/862-5829

For Release: Thursday,
February 14, 1985, 10:30 a.m.

Despite the slowing of price advances, neither congratulations about a "victory" over inflation nor complacency about the outlook are warranted, according to a policy statement just released by the Committee to Fight Inflation.

This is the sixth policy statement issued by the Committee since it was founded in June 1980. The Committee consists of a bipartisan group of former government officials and members of Congress. It is chaired by Henry H. Fowler, former secretary of the Treasury, and Herbert Stein, former chairman of the President's Council of Economic Advisers and a senior fellow at the American Enterprise Institute.

"The reduction of inflation to the neighborhood of four percent is in no sense a victory," the Committee says. Although four percent seems low when compared to the double-digit inflation peaks of the 1970s, it is well above the average rate of one and one-half percent that prevailed between the Korean War in the early 1950s and the outbreak of the Vietnam War in the middle 1960s.

The Committee notes that a four percent inflation rate cuts the purchasing power of the dollar in half in less than eighteen years, and is high enough to do enormous continuing damage to the economy and society. "Our objective should be a continued gradual reduction in inflation to the point where it is no longer a significant factor in personal and business decisions," it says.

Beyond the risk that inflation will not be slowed further, warns the Committee, is the more serious danger that it will accelerate again. Some forces that have helped slow inflation, including the strong dollar and ample world supplies of food and oil, cannot be counted on to continue indefinitely. Moreover, key government policies may well be formulated in ways that foster inflation. Since a persistent rise in the price level is a sign that demand is growing faster than supply, the Committee says, the obvious remedy is to slow demand and speed up supply. But the government may do precisely the opposite in its monetary, trade, and budget policies.

As to monetary policy, the Committee states that the recent progress against inflation can be credited mainly to the restraint on growth of private spending imposed by restrictive Federal Reserve policies since 1979. It notes, however, that the Federal Reserve is coming under increasing pressure to adopt an aggressively stimulative monetary policy. This course is urged by those who mistakenly believe that it will substantially increase the nation's rate of economic growth and thereby eliminate the problem of massive federal deficits. Force-feeding the economy with money might yield some temporary benefits in jobs and output, the Committee observes, but it would also result in throwing away the recent gains against inflation.

In the trade area, the Committee says, government measures to restrict imports amount to self-imposed contractions of supply that contribute to inflation, and that lower American living standards, in precisely the same way as a crop failure does. Although restrictions on imports may save jobs in the protected industries, they cost jobs elsewhere in the economy.

But the greatest threat, in the Committee's judgment, comes from the massive current and prospective federal deficits. By absorbing an enormous volume of private savings that would otherwise flow into domestic investment in plant and equipment, these deficits are reducing the nation's future rate of economic growth. And if the deficits begin to grow explosively--as they well may as a result of the workings of compound interest--the government may feel obliged to reduce the resulting burden of debt by resorting to inflationary policies. "This possibility represents the ultimate inflationary threat inherent in the federal deficit, and it alone would warrant a strenuous effort to bring the budget under control," the Committee says.

"Both the public and our elected officials must take the long view and the broad view," the Committee concludes. "They must not be beguiled into fostering inflation by arguments that take account only of the near term or the narrow interest. This is a formidable challenge. But it is one that can be met once the nature and the magnitude of the stakes involved are clearly understood."

The Committee is a bipartisan group of former government officials and members of Congress who have joined together to promote effective anti-inflation policies. Members are listed on the attached page. The American Enterprise Institute provides certain support services to the Committee but has no role in its substantive work; the CFI is solely responsible for its findings and its recommendations.

The American Enterprise Institute for Public Policy Research is a nonpartisan, nonprofit, research and educational institution, which itself takes no position on public policy issues. The views expressed in its publications, conferences, seminars, and forums are those of the authors and participants and do not necessarily reflect the opinions of the scholars, trustees, or staff of the Institute.

THE COMMITTEE TO FIGHT INFLATION is a bipartisan group of former government officials and members of Congress with extensive experience in the economic and financial area who have joined together to promote effective anti-inflation policies. The American Enterprise Institute for Public Policy Research provides certain support services to the CFI but has no role in its substantive work; the CFI is solely responsible for its findings and recommendations. The committee was formed in 1980 and its first chairman was Arthur Burns, who is now U.S. Ambassador to West Germany.

This policy statement, the sixth issued by the committee, was released on February 14, 1985.

Members:

Henry H. Fowler, Co-Chairman; former Secretary of the Treasury

Herbert Stein, Co-Chairman; former Chairman, Council of Economic Advisors

*W. Michael Blumenthal, former Secretary of the Treasury

Harry F. Byrd, Jr., former United States Senator

**Barber B. Conable, Jr., former Ranking Minority Member, House Ways and Means Committee

Frederick L. Deming, former Undersecretary of the Treasury

C. Douglas Dillon, former Secretary of the Treasury

Peter M. Flanigan, former Assistant to the President

Paul W. McCracken, former Chairman, Council of Economic Advisors

George H. Mahon, former Chairman, House Appropriations Committee

William Mc. Martin, Jr., former Chairman, Federal Reserve Board

Wilbur D. Mills, former Chairman, House Ways and Means Committee

*William E. Simon, former Secretary of the Treasury

John J. Williams, former Ranking Minority Member, Senate Finance Committee

*Did not participate in the preparation of this policy statement.

**Joined committee after this statement was prepared.

INFLATION REMAINS A PROBLEM—AND A THREAT

A Policy Statement by

The Committee to Fight Inflation

To be released at 10:30 a.m.
February 14, 1985

(For Release February 14, 1984)

INFLATION REMAINS A PROBLEM--AND A THREAT

A Policy Statement by the Committee to Fight Inflation

Only a few years ago, when the consumer price index was rising at a rate of more than 12 percent, inflation was widely perceived to be the nation's number one economic problem. Now that the rate of increase in the CPI has been reduced to about 4 percent, there is a widespread feeling that the problem has been resolved. Both in Washington and in the country at large the dominant attitude toward prices is a mixture of self-congratulation and complacency.

Neither congratulations nor complacency are warranted. The reduction of inflation to the neighborhood of 4 percent is in no sense a "victory." Such a rate may seem low after the double-digit peaks of the 1970's, but it is well above the average rate--1-1/2 percent--that prevailed between the Korean war in the early 1950's and the outbreak of the Vietnam war in the middle 1960's. A 4 percent inflation rate cuts the purchasing power of the dollar in half in less than 18 years; it is high enough to be deeply troublesome to individuals, businesses, and government, and to do enormous continuing damage to our economy and our society; and it should not be considered acceptable by our elected officials or by the public. Our objective should be a continued gradual reduction in inflation to the point where it is no longer a significant factor in personal and business decisions.

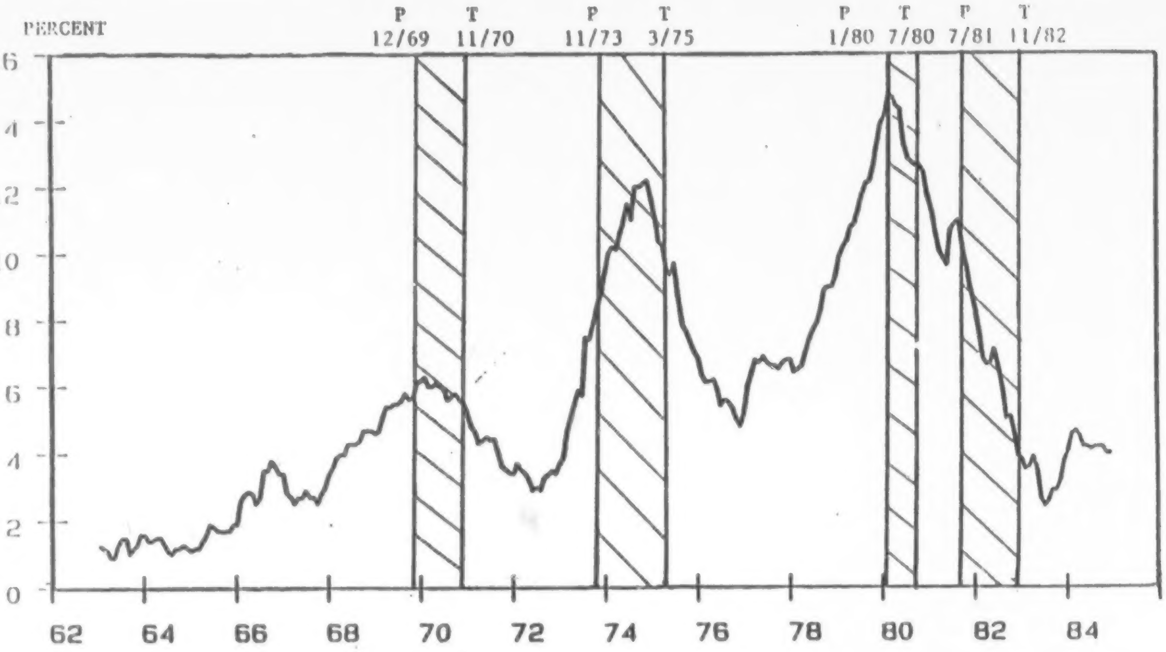
Beyond the risk that inflation will continue at about the current rate is the more serious danger that it will accelerate. It is worth noting that on both of the two previous occasions when inflation slowed to less than 5 percent--in the early and middle 1970's--it surged ahead again a few years later (see figure 1).

One reason for concern is that some of the forces that have recently helped slow inflation, including the strong dollar and ample world-wide supplies of food and oil, cannot be counted on to continue indefinitely. A second reason is that key government policies--in the monetary, budget, and trade areas--may well be formulated in ways that foster rather than fight inflation.

More stimulative monetary policies are now being urged in the mistaken belief that they will eliminate the problem of massive Federal deficits by substantially increasing the nation's rate of economic growth. And if the deficits are not quickly brought under control by budgetary measures, more stimulative monetary policies are likely to be pursued in the accurate belief that the real burden of the rapidly rising Federal debt can be reduced by cheapening the dollars in which it is measured.

Meanwhile, the Federal deficits are contributing to inflationary pressures indirectly, by absorbing private savings that otherwise would be available for productivity-enhancing private investment. In the trade area, government measures to restrict imports of both industrial materials and consumer goods are contributing to inflation by reducing pressures on competing domestic industries to hold down wage and price increases and to strive for continuing gains in productivity.

FIGURE 1: Rates of Change in the Consumer Price Index, 1963-1984



NOTE: Percent change over preceding twelve months. Each vertical shaded area is a business cycle recession, defined as the period between the date of a peak (P) in business activity and the ensuing trough (T), as established by the National Bureau of Economics Research, Inc.

SOURCE: Bureau of Labor Statistics.

The Committee to Fight Inflation, a bipartisan group of citizens who have had major governmental responsibilities in the economic and financial area, has issued five policy statements since June 1980. In this new statement we indicate why inflation should continue to be a matter of intense concern, and we describe the kinds of government policies that are required if our nation is once again to enjoy vigorous economic growth in an inflation-free environment.

In general, we urge that the government move promptly to bring the Federal deficits under control; that it gradually reduce the rate of increase in total private spending by slowing growth in the money stock; and that it seek to accelerate growth in supply and in the productivity of the economy by fostering conditions conducive to private investment. These are the obvious remedies for inflation, since a persistent rise in the price level is a sign that demand is increasing faster than supply. As indicated above, however, we fear that the government will pursue precisely the opposite policies--that it will act aggressively to strengthen demand and to weaken supply. Our reasons for concern are spelled out in the following three sections. The final section describes in broad terms what we believe must be done.

Monetary policy and demand

The recent progress against inflation can be credited mainly to governmental restraint on growth of total private spending in the economy--specifically, to the restrictive monetary policies pursued by the Federal Reserve during most of the period since 1979. The recessions of 1980 and 1981-1982 were an inevitable by-product of that restraint; the loss of jobs and output they entailed were the price the nation paid for the abatement of inflation from about 12 to about 4 percent.

Following the second of these recessions real output grew vigorously for nearly two years before slowing in mid-1984. No further progress was made against inflation in this period, which is not surprising in light of the rapid pace of output growth; indeed, the absence of any significant acceleration might be considered a source of satisfaction. But further progress can and should be made in the years ahead, when real output can be expected to expand at a more moderate and therefore more sustainable rate. To this end, monetary policy should be directed at the long-run objective of gradually reducing the rise in spending to the rate at which supply is trending upward. That, in turn, will require continuing monetary restraint, in the form of a gradual but persistent reduction in the growth rate of the money stock. Such restraint might well be associated with falling interest rates, particularly if it leads to a further abatement of inflationary expectations.

While continuing monetary restraint is clearly needed, popular support for it has been weakened by the complacency about inflation. Meanwhile the Fed is coming under increasing pressure to adopt an aggressively stimulative policy by those who argue that rapid expansion of the money stock will raise the growth rate of the economy well above rates that have proved sustainable in the past. Pressures for monetary stimulus would greatly intensify if it appeared that a recession was imminent.

A sharp acceleration in monetary growth at this point might yield some temporary benefits in jobs and output, but only at the cost of a subsequent acceleration of wages and prices. By force-feeding the economy with money we would be throwing away the recent gains against inflation--gains for which the nation has paid dearly in lost jobs and lost output. But beyond that, we would be condemning ourselves to renewed losses of jobs and output in the course of the next campaign against inflation, which would surely be necessary. It is true, as some advocates claim, that faster monetary growth would reduce the burden of the Federal debt, but it would do so by cheapening the dollars in which the debt is measured rather than by raising the nation's rate of economic growth.

More generally, a sharp acceleration of monetary growth would serve to perpetuate the pattern of the past two decades, in which periods of accelerating inflation alternated with painful recessions. Monetary policy should not be diverted by the demands of those not satisfied with feasible economic growth rates from its long-run objective of overcoming inflation by gradually reducing the rate of increase in private spending.

Supply considerations

The Fed's anti-inflation efforts since 1979 have been greatly aided by favorable supply developments in food and energy: bountiful harvests here and abroad have held down price increases for food, and the world-wide oil glut has led to declines in energy prices. But we cannot count on an indefinite continuation of these favorable circumstances; the future may well hold further "supply shocks" of the kind that contributed so heavily to the inflationary surges of the 1970's. This possibility makes it even more essential that the Fed persevere in its anti-inflationary effort now, while conditions in food and energy markets are still favorable.

Similarly with respect to another force that has been making a major contribution to the abatement of inflation: the marked strengthening of the dollar in foreign exchange markets that has been under way since 1980. The strong dollar has reduced the cost of imported supplies of both consumer goods and industrial materials, and it has sharply constrained the ability of competing domestic producers to raise wages and prices.

This situation also must be considered temporary; the world is accumulating dollar assets at a rapid rate, and its appetite for such assets will sooner or later be sated. At that point the dollar will stop strengthening, and it may begin to weaken. Along with the supply shocks in food and oil, a weakening dollar contributed to the inflationary pressures of the 1970's and may well do so again.

Meanwhile, the effect of the strong dollar in intensifying foreign competition in many domestic markets is fostering a rising tide of protectionist pressures. The rapid growth of imports in recent years has given new force to the old complaint that imports threaten American jobs and living standards, and the government appears to be increasingly ready to respond to that complaint by limiting competition from abroad.

In the past year, for example, the administration negotiated a renewal of the "voluntary" quotas on imports of Japanese cars, tightened regulations governing textile imports, and effectively cartelized the domestic steel market by persuading foreign governments to limit their steel exports to the United States to specified shares of the market. And Congress did its bit by enacting legislation that makes it easier for domestic firms to win protectionist rulings from the International Trade Commission.

Such restrictions on imports amount to self-imposed contractions of supply: they contribute to inflation--and they lower American living standards--in precisely the same way as do reductions in food supplies due to crop failures or reductions in oil supplies engineered by a foreign cartel. Moreover, restrictions on imports do not even have the merit of serving their nominal purpose of protecting American jobs and living standards, because they cost as many jobs elsewhere in the economy as they save in the protected industries. That import restraints cost jobs is obvious when foreign countries retaliate with barriers against our exports, as they often do. It is less obvious, but still true, even in the absence of retaliation. The mechanism is simple: any cutback in our imports reduces the supply of dollars in foreign exchange markets, adding to the strength of the dollar and, therefore, to the general price advantage of foreign producers over their American competitors. Import quotas do not make jobs; they simply shift them around.

Import quotas are particularly regrettable because they are likely to long outlast the particular circumstances, such as a strong dollar, that initially spawn them. As experience demonstrates, it is far easier to extend protection to an industry than to withdraw it.

The role of the budget deficit

In a policy statement issued a year ago our Committee noted that the massive federal budget deficits in prospect for coming years threatened to reignite inflationary pressures and to do other damage. [1]

---

[1] See "We Must Act Quickly to Curtail the Federal Deficit," AEI Economist, February 1984.

We urged prompt action to narrow the extraordinary gap between federal expenditures and receipts through a package of spending cuts and revenue increases. While we described one possible package, we added that the need to act quickly vastly outweighed the need to do so in any particular way.

Some observers have argued that such expressions of concern about the deficits are exaggerated. As evidence, they note that inflation has not, in fact, accelerated over the past year despite the lack of any significant progress in reducing actual and prospective deficits.

In our judgment the dangers posed by the massive deficits are, if anything, clearer today than they were a year ago. The hope that the deficit would be reduced sufficiently by economic growth alone, without action on spending or taxes, is more forlorn now than earlier. Estimates of the burden of interest charges on the debt in the years ahead have increased significantly. And the fear that a strong dollar would foster a growing wave of protectionist measures has been amply borne out by developments. Admittedly, the strength of the dollar cannot be attributed wholly to the federal deficit; it reflects the great many factors that have increased the attractiveness to investors around the world of assets denominated in dollars compared to those denominated in other currencies. We believe, however, that relative interest rates are prominent among such factors, and that interest rates in U.S. credit markets are higher than they would otherwise be as a result of the enormous volume of funds the Treasury continually drains from those markets in financing the deficits.

The Treasury's demands on credit markets are in direct competition with those of business firms seeking funds for investment in plant and equipment. The magnitude of the Treasury's demands is suggested by the fact that the federal deficit for fiscal 1985, currently estimated at $222 billion, amounts to more than 5 percent of dollar GNP, whereas net private saving--the main source of funds for financing new investment and the deficit--is currently equal to about 7 percent of GNP. Clearly, the Treasury is absorbing an enormous volume of funds that would otherwise flow into private investment, and it is thereby reducing the nation's future rate of economic growth.

The recent heavy net inflow of funds from abroad has, of course, supplemented domestic saving as a source of funds in U.S. credit markets and thus has moderated the immediate impact of Treasury borrowing on the availability of funds for domestic investment. As suggested earlier this inflow cannot be counted on to continue, but even if it did it would be a poor substitute for domestic financing. When foreigners replace Americans as the suppliers of investment funds to American industry, they also replace Americans as the owners of the future income streams those funds generate. To borrow heavily from the rest of the world in an effort to cover the combined credit needs of the U.S. Treasury and domestic industry is to mortgage our economic future.

As grim as this prospect is, the outlook will be considerably worse if the deficit begins to grow explosively--as it well might as a result of the workings of compound interest. In fiscal 1984, when the deficit was $185 billion, interest payments equaled $111 billion, or 60 percent of the deficit; the rest was accounted for by a $74 billion gap between revenues and outlays for all purposes other than interest payments. If in some future year revenues were brought into balance with outlays for other purposes, the budget would be in deficit by the amount of interest payments. Since each year's deficit adds to the outstanding debt, the debt would continue to grow over time, at a rate equal to the average interest rate paid by the Treasury.

The debt--and the interest charges on it--would, of course, expand faster if revenues continued to fall short of outlays for other purposes, as they undoubtedly will unless vigorous deficit-reducing measures are taken. And the debt would expand faster still if the Treasury was obliged to pay progressively higher interest rates in order to find buyers for its continually expanding volume of security issues. In that event the whole process would become explosive, with the deficits absorbing a volume of funds rising further and further above the level of net private saving. The nation would then find itself unable to replace its depreciating capital stock; it would experience not just a slowdown in growth but a persistent decline in its capacity to produce goods and services.

Such a prospect is simply intolerable, and there is little chance that it will ever come to pass. If the government fails to cope with its deficits and its debt in the straightforward way--by a combination of spending cuts and tax increases--it will almost certainly resort to the ready alternative of inflation. The government can always reduce the burden of the debt to any degree it desires by shrinking the real value of the dollars in which it is measured. This possibility represents the ultimate inflationary threat inherent in the federal deficit, and it alone would warrant a strenuous effort to bring the budget under control.

What must be done

The problem of inflation poses a fundamental challenge to the citizens and the elected leaders of our nation, along with those of the world's other democracies. Both the public and government officials must be prepared to support a consistent anti-inflationary stance for monetary policy, forgoing any short-run benefits to jobs and output from monetary stimulus in the interest of fostering the long-term growth in jobs and output that will be possible if inflation is overcome. They must resist the strong and growing pressures for protection from foreign competition, forgoing any benefits to jobs and output in protected industries in the interest of avoiding losses in jobs and output elsewhere; and in the interest of avoiding the costs to the nation, in the form of more rapid inflation and lower living standards, that flow from any contraction of supplies. And--most importantly--they must support vigorous measures to reduce our massive federal deficits in this session of Congress; every delay makes the task more difficult, and we are close to the point at which it might appear hopeless.

In weighing policies, both the public and our elected officials must continually keep in mind:

. that the nation can enjoy vigorous long-term economic growth only when inflation is overcome;

. that inflation will be overcome only when the growth of demand is once more approximately equal to the rate at which supply is trending upward;

. that the attainment of that objective requires slowing demand and speeding up supply--not the contrary; and

. that a failure to curtail the federal deficits now may lead these deficits to grow so rapidly that the government will feel obliged to resort to inflationary policies to deal with them.

In brief, both the public and our elected officials must take the long view and the broad view; they must not be beguiled into fostering inflation by arguments that take account only of the near term or the narrow interest. This is a formidable challenge. But it is one that can be met once the nature and the magnitude of the stakes involved are clearly understood.

The **Chairman**. Thank you very much, Mr. Fowler.

The hour of 11 o'clock has arrived, but a quorum of our committee has not. The Chair can count at least six members here, and we will need nine in order to take action on the nominees, so if I may have your understanding, Mr. Hormats, as a veteran of such experiences before, if the Chair should sight nine members of the committee present, I will ask that we interrupt your testimony and consider the nominees. These negotiations with the Soviets, I would think we would agree, are important, and then we will proceed back to the global economic situation after that point.

We are delighted that you have come. Mr. Robert Hormats is now vice president of Goldman Sachs & Co. of New York. He has had many experiences with this committee in various capacities, and we are happy to greet you today.

Senator **Cranston**. Mr. Chairman, Senator Pell is here. Do you know if others are on their way, so that we can do this soon?

The **Chairman**. We have indications that four are on the way and two are in the back.

Senator **Cranston**. We will need one more, then.

The **Chairman**. Senator Kerry is en route, apparently.

[Pause.]

The **Chairman** We will hold for just a moment, Mr. Hormats. We may in fact have a quorum.

Senator **Mathias**. It may be good for them to hear Mr. Hormats.

[Whereupon, at 11:06 a.m., the committee recessed, to convene immediately in a business meeting, following which, at 11:11 a.m., the hearing resumed.]

The **Chairman**. We will proceed now with our distinguished panel, and specifically with the testimony of Mr. Robert Hormats, vice president of Goldman Sachs & Co.

STATEMENT OF HON. ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN SACHS & CO., NEW YORK, NY

Mr. **Hormats**. Thank you, Mr. Chairman. I appreciate the opportunity to testify at this important set of hearings. I look back at the history of this type of hearing, and it seems that the last set of hearings of this type was held by Senator Fulbright about 20 years ago when he looked comprehensively at all the interrelationships among the key aspects of U.S. foreign policy and international economic policy.

Let me just make a few general points about international economic policy and its significance to the United States. One point that I think is increasingly clear is that the U.S. economy and health of the U.S. economy depends heavily on the world economy. Roughly 12 percent of our GNP is trade related.

Our banks are at the center of a highly interdependent international financial system. More and more industries and our agriculture has to compete with foreign producers, some of whom are subsidized. More and more we are seeing that the international economy and the national economy are really the same things to a large degree. It is very hard to draw the line between the two.

Second, the health of the world economy has an important effect on the security and the political relations of the United States. The

NATO alliance is heavily dependent on a prosperous Europe. Weakness in the European economies is a direct threat to that alliance.

Third, the problems of the developing countries have a great impact on the United States. The debt problem, as we have seen, had an effect on the U.S. financial system, and the weakness of Latin American economies, as has already been pointed out by Dick Cooper, led to a major problem for the United States in trying to sell to Latin America and led to a huge turnaround in our trade with that area.

More and more, however, there is a reassessment in those countries. A lot of them now are realizing that the policies of the seventies that led to the debt crisis in part have to be changed.

We have also seen some remarkable developments in East Asia, where more market-oriented, more open economies have done quite well, and I think there is more of a move toward pragmatism in the Third World, which I think is a positive development.

Fourth, the institutions that were created after World War II have to a degree, particularly the GATT, become somewhat rusty, and changes are needed in those, and American leadership is going to be required in order to make the necessary changes to modernize the institutions of the international financial system.

Let me talk for a moment about the dollar. That has been covered to a large degree, but there are a couple of additional points I thought I might make about that.

One, it seems to me that the problem with the dollar results from a number of factors. One element of that is high interest rates in the United States, but that was really more of a problem relative to Europe and relative to other countries in the early part of 1984.

In the latter part of 1984, we saw a decline in the gap between interest rates in dollar denominated assets and interest rates in foreign currency denominated assets. In other words, there was not as large an interest between interest rates in the United States and interest rates in most of our other countries, and in fact while that decline was taking place, the dollar increased, so we have to look beyond simple interest rate differentials.

Another point that I think is interesting to note is that part of the demand for dollars resulted from a shift from an inflationary environment in the 1970's to a noninflationary environment today.

In the 1970's it paid to buy real goods, gold, real estate, things that appreciated in value, whereas financial assets were not a particularly good buy for some investors because inflation was high and in some cases financial assets paid a very low interest rate.

Today, in a noninflationary environment, with relatively high interest rates, there has been a move toward financial assets and a weakening of gold, silver, and a lot of other hard goods.

Now, the question is, where do you put your money when you sell those things? One interesting thing is that today over two-thirds of the world's financial assets are denominated in dollars, so the very switch from holding real goods to holding financial assets also meant a switch into dollars relative to other currencies, which has created an underlying demand for dollars.

Third, inflation in the United States has been held down. The Fed is committed and vigilant to preventing an increase in inflation, and that, of course, has helped to strengthen the dollar as well.

In addition, there has been increased business demand for dollars. The point was made that American banks, instead of lending abroad, as they did 2 or 3 years ago, have had a very high degree of business demand today, and money that was originally lent earlier to other parts of the world, Latin America, Europe, and other parts of the world, is now being lent to sop up this huge increase in business demand.

That, I think, is also an important reason for the strength of the dollar. Another point that has been made is that Treasury borrowings are very high. Roughly 20 percent of our Federal deficit is financed by foreign savings, and an additional substantial amount is more easily financable as a result of the in-flow.

The reason we have not had the feared crowding out that people thought might occur from the Federal deficit is in part because we have been able to draw on foreign savings. I think that has been one important reason that interest rates have not gone up more than they otherwise might have.

These are the sort of pull factors. There are also push factors. That is, European economies are simply not growing at a high enough rate to attract or hold a lot of money. In Latin America we have seen a big outflow of capital. These are in effect a push of capital out of those countries into the very attractive American capital market.

Europe's problems, I think, bear a moment of attention, because European problems are deeper than simply the current environment. As much as Europeans are concerned, and rightly concerned, about the dollar and about U.S. interest rates, there are some broader and deeper problems in Europe. One question that might well be asked is, why, with Europeans having increased exports so much to the United States, have their economies not grown in response? Why have they not picked up?

Well, one reason is, there are a lot of rigidities, underlying rigidities in the European economies. There are barriers among the European countries as each government tries to carve out a larger share of its national market for national industries, and this has cumulatively led Europeans to think that perhaps the stimulus as a result of higher exports to the United States is positive but really is not a harbinger of increased profits and an improved investment climate.

Let me turn a bit to the relationship between economics and security. Two points here are important. One, if you continue to get high unemployment and all sorts of other difficulties in Western Europe, it makes it more difficult for the Europeans to shoulder their share of the defense burden, and that adds to the acrimony between the United States and Europe over this particular point.

It also leads the Soviets when they are making their calculation about arms control policy to think that perhaps if they simply wait, the current, relatively pro-NATO, in some cases strongly pro-NATO governments, will not be there 2 or 3 years from now, and they will get the softening up of support for arms for a strong

NATO, and that will lead to a reduction in Western defenses even without having to agree to an arms agreement.

The second thing is that in many cases, unless we move toward greater reliance on conventional forces, the undermining of or the concern in the West about the massive nuclear deterrent will also undermine support for NATO.

One reason we do not move more toward conventional forces is, it is very expensive, and with tight budgets and large social demands, we are simply not able to allocate the resources necessary, so there are very close links between the NATO force posture and our ability to negotiate an arms control agreement and the economic health of the alliance.

I have mentioned and put into my testimony some discussion of north-south economic issues. Henry Fowler made a very good point on this. That is that this is an extremely important part of our economic requirement in the world, and that is to have growth in the developing countries. There are big markets for our products, and our lack of growth in those countries also breeds great instability.

Now, over the last couple of years we have seen a reassessment in some countries in policies and some success in countries of East Asia in particular. It strikes me that we have an opportunity to change the focus of the North-South debate from what used to be a relatively ideological debate to one that is much more practical and pragmatic, but we have to be in the game. We have to continue to provide the support to the multilateral development institutions that is needed to help these countries undertake the structural changes that they need to avoid a recurrence of the debt problems that we saw a couple of years ago and to deal with some of the underlying problems in Africa and other parts of the world which have led to this tragedy that we see in Ethiopia and other areas of Africa.

So, there is still much to be done, but there is a very hopeful set of signs that they are thinking again about their domestic policies, and some of the old inward-looking policies will be changed as countries that pursue those policies see the successes of other developing countries which have pursued more outward-looking policies.

With respect to the multilateral institutions, I would simply say that in looking at them again, the IMF has proved its vital role as center of the international financial system. It was indispensable in dealing with the debt problems of 1982 and 1983. It continues to need support. Likewise, the World Bank, for a different set of reasons. The GATT, it strikes me, really needs a major effort by the United States if it is to be improved.

I do not think we can have a traditional Kennedy round or Tokyo round type of negotiation right away, largely because I do not think the GATT has the credibility any more. It does not have the respect. People evade it. People find ways of going around it, and it really does not resolve disputes quickly or in the judgment of some as fairly as it might.

It seems to me what we really need at this time is a slightly new type of trade negotiation where we first focus on improving the procedures of the GATT, making it work more fairly and effectively, and certainly more expeditiously.

Then, once we have established its credibility to a greater degree and confidence has been built up among negotiators, we can then move as we need to, to reduce the barriers in the trading system, but we have to get the procedures right, before we do that.

We also need in this country a much better consensus as to where we are going in the next round of trade negotiations. I think Ambassador Brock has done an outstanding job in identifying the key issues.

I do think, however, we need more of a rapport with the private sector. President Nixon established what was called the Williams Commission at that point to draw on the thoughts of the private sector, labor, business, consumers, in establishing the consensus for negotiation.

It strikes me that in the time we have allotted now as we are thinking about establishing negotiation which the President committed himself to quite constructively, in my view, in his State of the Union speech, we ought to try to get together a broad consensus as to where we want to go and how we want to negotiate, what we want to give and what we want to get.

I would simply conclude by saying that in order to establish growth we have to do several things: One, make the system work better; two, try to find some ways of generating a greater degree of global growth—the budget deficit is very important.

It strikes me that those who think reducing the budget deficit is going to pull the dollar down are probably missing two basic points. One is, if interest rates come down in the United States because of a reduction in the budget deficit in this country, other countries will bring their interest rates down to match, so we will not have that interest rate effect of money going from the United States to Western Europe or other parts of the world. That will not bring the dollar down, because others will match us.

Second, simply bringing interest rates down in the United States does not mean people are going to move out of dollar assets. They may simply move from debt instruments to equity instruments. So that will not be the thing that does it. What will do it and what can do it, I think, is by bringing interest rates down in the United States.

You will enable the Europeans to bring their rates down. That will stimulate more growth in Western Europe and other parts of the world. It would also mean that the Latin Americans and others could use a greater percentage of their earnings not to repay debt, but to increase their own investment.

Support for the multilateral institutions, I think, is vital. I think there are things that the Europeans themselves could do. There are a lot of rigidities in the European economies and even bringing interest rates down is not necessarily going to mean that there will be a higher rate of growth in Europe unless they deal with some of the rigidities internally.

They have made progress there. There is a lot of technological development going on in Western Europe. I am not a Europessimist, but I do think that they need to go further to improve their own domestic environment.

I was struck on the list that Mr. Fowler read that almost everything on that list was something that the United States had done wrong. Well, we make our share of mistakes, but I think Europeans also have to look a little bit more at some of their policies, because they are not perfect either.

A new round of trade negotiations, I think, really deserves great support, because the trading system is deteriorating. If it deteriorates our agriculture and our industry are going to be hurt very badly.

Finally, with respect to the IMF, it strikes me that we need to at least have a better framework for exchange rate intervention decisions and for trying to avoid these major misalignments which cause distortions in trade. I am not a great believer that intervention is a panacea, but I do think there are times when exchange rates enter sort of danger zones which cause distortions, and at that point you need to have a greater degree of coordination to determine how to deal with it and how to bring those currencies out of those danger zones.

There are great opportunities before the United States over the next couple of years. Our economic progress over the last several years has been very positive. It has given us an opportunity to consolidate that recovery by making the sort of domestic changes dealing with our budget problem and also strengthening a lot of aspects of the world economy.

If we do that, and if we do it in an expeditious way, I think we have the opportunity of sustaining our own recovery over the next several years and also reinforcing that by having the world economy be a much healthier place.

I would simply leave you with one interesting statistic which illustrates the dimensions of the dollar problem and why that is particularly a problem for the United States and for the world.

Today, or a couple of days ago, at least, we find the dollar and the pound roughly at a 1-to-1 relationship. The last time that occurred was in the year 1774, a long time ago. I think it illustrates the enormous change which has occurred in these exchange rate relationships, and just how striking it is to Americans who have to trade and the Europeans who look at it from the other side.

So, it strikes me that we have to realize that this is a problem. The dollar in effect may turn out to be the Achilles' heel of this recovery, and somehow we have to deal with that. We have to deal with our overall trade deficit and our budget deficit.

I think if we do that, and we do the things necessary to improve the world economy and its structure, we have the possibility of a very long and very healthy world recovery.

Thank you.

[Mr. Hormats' prepared statement follows:]

PREPARED STATEMENT OF HON. ROBERT D. HORMATS

Mr. Chairman: I appreciate the opportunity to appear before the Foreign Relations Committee in this series of hearings on the future of American foreign policy.

Not since the hearings held under the chairmanship of Senator Fulbright nearly two decades ago has this committee undertaken so comprehensive an examination of the various aspects of U.S. foreign policy—with their myriad linkages, their enormous complexity, and their profound implications for the very survival of this country and this planet. Through these hearings, the Committee has a unique opportunity to clarify and strengthen public understanding of this country's fundamental interests in the world and to help shape American foreign policy for years to come.

Before turning to the subject I have been asked to address—America's role in the world economy and how we can stimulate and sustain global economic growth—I would like, in the spirit of these hearings, to put this subject in its broader context.

To be successful, American foreign policy must appeal to the hearts and minds of the vast majority of Americans. In order to do this, it must be seen as promoting America's vital interests: our security, the security of our friends and allies, our prosperity and that of countries whose economic health is important to us, and fundamental human rights and liberties.

No government, of course, can pursue all of these with the same degree of zeal and success at precisely the same time. And there are often moments when the pursuit of one will conflict with that of another. Moreover, the executive and the Congress must often settle for the best solution that can be achieved at the time, rather than the best that can ultimately be imagined. But, in the final analysis, these interests must be at the core of American foreign policy if it is to enjoy sustained domestic support, without which it is credible neither at home nor abroad.

In shaping U.S. foreign policy, it is important to recognize how truly unique in history we in this country are. Power, freedom, and prosperity have never come together so intimately and so intensely as they do in the United States in this century. History records many nations with great power but little individual freedom, and many with considerable freedom and prosperity but with little power. The United States is blessed with all three. We need to have a strong consciousness of the historical importance of this fact and the great opportunity it provides us.

But opportunity does not always translate into the wisdom to use it constructively. Nor do societies always recognize their strengths. Many nations with military power and valid causes have receded because they had sufficient confidence in neither. And others have been unable or unwilling to bridge differences with adversaries even when circumstances gave them a reasonable chance of success.

For the remainder of this decade and into the next, this country will be faced with a formidable set of challenges: reducing the number and the risk of having to use nuclear weapons, strengthening our alliances in the Atlantic and Pacific, promoting the peace process in the Middle East, furthering economic growth and political normalization in Asia, and overcoming the legacy of the debt crisis in Latin America as well as the desperation of hunger and poverty in many parts of the developing world.

Economic factors will play a major role in our ability to meet these challenges. A vigorous U.S. economy—which is essential to the continuing improvements in human opportunity and well-being we seek in this nation—is also a prerequisite for a strong military and an effective foreign policy. It provides the resources on which both ultimately depend. And our success in creating jobs and generating new technologies makes others more receptive to our market-oriented philosophy.

But it is increasingly true that a vigorous U.S. economy depends on a healthy world economy—and that does not exist today. Nor is it easy for a nation which has so long taken pride in its self-sufficiency to recognize how intimately wrapped up in the future of the world economy is our own economic well-being. However, with trade accounting for over 10 percent of our GNP, our industries being challenged by foreign competition, our banks at the center of a multi-billion dollar international capital market, and our budget deficit financed to a significant degree by foreign savings, it is virtually impossible to distinguish between domestic and foreign economic policy. In reality we are living in a world drawn together by trade, finance, technology and new forms of communication into a proximity and interdependence for which we are psychologically, politically and institutionally ill prepared. Our policies, our institutions and most of all our way of thinking must catch up with the realities around us.

Because the condition of world economy has such an important effect on our own, there are strong domestic reasons for an international economic policy that promotes a growing world economy, puts great emphasis on our trade and competitiveness, reduces currency distortions, and helps to alleviate developing country economic difficulties.

And there are other policy goals to be served. First, there is a direct relationship between the economic health of our Western allies and our security and ability to negotiate arms reductions. Second, the remarkable economic and technological achievements of a number of East Asian countries, and the rethinking of policies following the debt crisis in many Third World nations, provide an opportunity to refocus the debate over economic development from ideological to practical considerations. Third, much of the original architecture of economic cooperation established soon after World War II has been overturned or become outdated; without adequate vision and leadership on our part, new and improved rules and institutions will not emerge.

THE RELATIONSHIP BETWEEN THE U.S. ECONOMY AND THE WORLD ECONOMY

It is useful at the outset to describe the relationship between the U.S. economy and the world economy—and particularly how the dollar, our trade deficit, and the weak growth in other countries are interrelated.

The "super dollar" is, in one sense, the most visible link between the U.S. economy and the world economy. It simultaneously has helped to hold down inflation in this country and imposed an enormous burden on U.S. industry and agriculture, which must compete with foreign products. As such it is both an important reason for the sustainability of the current recovery and possibly its Achilles Heel.

While there are several reasons for the dollar's spectacular surge, three stand out. High U.S. interest rates were a major factor last year and remain an important one. But from early July 1984 to early January 1985 the interest rate spread between dollar-denominated securities and those denominated in other major currencies narrowed significantly; yet the dollar's foreign exchange value increased. We must therefore look for other sources of the dollar's strength.

One of these is the change from an inflationary to a non-inflationary world environment. In the 1970s, investors preferred to hold real goods (such as gold and real estate) which appreciated in value due to inflation, while financial instruments (which paid a low or negative real interest rate and were eroded by inflation) were considered less desirable. In the current low inflation environment, with high real interest rates, investor preferences have shifted massively back to securities. And because more than two-thirds of the world's securities are dollar-denominated, that shift in itself has created an enormous surge in demand for dollars. The move away from inventory overhangs (which were good business when prices were constantly rising) to tighter inventory management is also a function of the shift from an inflationary environment to a non-inflationary one; and the attendant increase in liquidity has also added to dollar demand.

In addition, recent progress in the United States in reducing inflation has been impressive. And the Fed has made it clear that it will continue to be vigilant in fighting inflation. Moreover, past increases in the dollar's value have helped to restrain prices. This anti-inflationary record has added considerably to confidence in the dollar.

In addition U.S. economic growth that brought with it profitable investment opportunities and an increased business demand for funds. U.S. corporate borrowing in Euromarket has been strong. So has borrowing in Europe by banks to meet U.S. customers needs. Moreover, American banks, with greater demand for funds at home than abroad, have reduced foreign loans. And their continued caution about several Latin American countries has resulted in sharp cuts to that area.

The Treasury's borrowings have, to be sure, also been a major factor in the dollar's strength. Roughly 20 percent of the federal deficit has been financed by foreign funds and a much larger percentage is made more easily financeable. Indeed, one reason that interest on the federal debt has not increased as dramatically as it otherwise might have in light of the huge budget deficit is that foreign savings were available to help finance that deficit. And the feared "crowding out" effect also has been averted by this capital inflow.

All of these factors constitute a "pull" of funds from abroad to the United States. But there is also a "push" factor. In high savings countries such as Japan, investors cannot find profitable investments adequate to absorb their remarkably large pool of savings. So they seek investments in other parts of the world; and the United States is particularly appealing to them. This adds to demand for dollars.

In other countries many investors do not find domestic opportunities sufficiently attractive; hence, the "push" of capital abroad. Again much goes to the United States. In the case of a number of Latin American countries, tight fiscal and monetary policies, low growth prospects, financial and in some cases political uncertainty, and an often negative attitude toward foreign investment limit their attractiveness to domestic and foreign investors. Capital flight and lack of vigorous domestic investment have been the result.

In Europe the situation is even more complex. Its exports to the United States surged by over 30 percent last year. Yet this has not triggered a significant increase in investment and growth there. Because of many economic rigidities, intra-European barriers caused by national policies to preserve a large market share for domestic industries, a weak venture capital market, high labor cost and low labor mobility many potential investors see exports as a welcome stimulus but a "singular" event rather than a harbinger of a general improvement in profits and growth prospects. Consequently investment has been disappointingly weak; and funds flow to investments across the Atlantic.

Finally, Europe's investment picture is clouded by the fiscal and monetary policies of a number of its governments. These policies are made more difficult to manage because of the dollar problem and high U.S. interest rates. Several European countries have achieved significant reductions in their structural budget deficits since 1980. But interest rates—which might otherwise have been reduced to offset this fiscal tightening—have had to be maintained at relatively high levels in order to prevent a further weakening of their currencies. However, high rates, in turn, have reduced growth prospects and thus the incentive to invest in these economies. This weakness in investment, paradoxically, tends to put downward pressure on the very currencies the high interest rates were meant to strengthen.

But while the dollar has received the most attention as the cause of the U.S. trade deficit it is not the only cause. The Latin American debt crisis and its legacy of economic austerity have limited U.S. exports to that region and made these countries more reliant on the American market to earn money to service their debts. The weakness of European economies has slowed the growth in our exports to them and made their companies more zealous in selling abroad, particularly to the United States. And the drop in oil prices has cut U.S. sales to OPEC countries.

However, despite the weakness in growth of some of our major trading partners and the 35–45 percent strengthening of the dollar, U.S. exports managed to increase by 12 percent in 1984. Office equipment, such as computers, and airplanes led the way. This increase is largely the result of a higher rate of growth abroad in 1984 than in 1983 and the technological and quality advantages of many U.S. products.

The real deterioration in the U.S. trade deficit came as the result of increased imports—which surged by 34 percent in 1984. This was a result of both high growth in this country and the sharp increase in the dollar. The latter both attracted imports by giving them a major competitive advantage and created an incentive to source off shore. Both took a major toll of employment and profits in the U.S. manufacturing sector. In so doing they intensified the shift already underway from tradeable to non-tradeable goods. And both are creating long term structural problems—which are at this point difficult to measure but nonetheless quite apparent—by weakening the industrial and agricultural base of our economy.

THE RELATIONSHIP BETWEEN ECONOMICS, SECURITY, AND ARMS CONTROL

There is also a direct relationship between growth and security. As large numbers of Americans and Europeans insist that NATO rely less on a strategy of massive nuclear deterrence, the Alliance depends increasingly on it. Greater reliance on conventional forces would command greater public support, and has been recommended by senior military officers. But increasing our conventional force structure is expensive—which is one reason the decision was made years ago to rely so heavily on nuclear weapons.

Slow economic growth, budgetary constraints and pressing social demands in many Western European nations limit resources available for—and the political will to allocate resources to—the conventional force increase necessary to reduce reliance on nuclear deterrents. There are also budgetary inhibitions in the United States. The situation risks a weakening of popular support for NATO—a weakening which could reduce the Soviet incentive to strike an arms limitation agreement in the belief that Western public opinion will force leaders to cut back on NATO defenses without one.

Europe's economic difficulties also create social problems. High unemployment, especially among young people, has led to alarming internal pressures—particularly in West Germany, the European country most vital to the Alliance. And unemployment could also threaten the survival of governments that strongly support the alliance and strengthen parties less well disposed to it.

In addition, if Europe's economy does not improve and social problems continue, there will be growing pressures for cuts in defense budgets. This would add fuel to the already acrimonious trans-Atlantic debate over defense burden-sharing and to demands in the United States for troop withdrawals. Pressures here to reduce our budget and trade deficits will worsen these strains. The situation would hardly improve the prospect for Western security cooperation or incentives for Moscow to come to an arms agreement.

Trade dispute also have important security implications. The enormous U.S. trade deficit in 1984, and the prospect of a much larger one in 1985, magnify trade frustrations in this country and intensify anger, which has been growing for several years, over foreign subsidies and restrictions on American goods and services.

And high rates of unemployment in Europe make its leaders sensitive to measures by other countries which impair its exports. They also argue that arms trade is not a "two-way street" because the U.S. buys relatively few weapons from them while they buy large amounts from the United States.

A trade war or a series of major trade skirmishes would, in addition to doing major economic harm, deepen divisions among the United States, Europe and Japan. The Soviets in the past have sought to capitalize on such divisions. Presidents Kennedy and Nixon well understood this. Both initiated negotiations to resolve trade problems while undertaking sensitive arms talks with Moscow.

NEW OPPORTUNITIES IN NORTH-SOUTH RELATIONS

The international (primarily Latin American) debt problem, which as noted above has been one factor in the U.S. dollar and trade problem, has resulted in a rethinking of economic policy in a number of developing countries. And the success of several East Asian nations has provided examples of the types of policies that appear development process.

The North-South debate has, for a number of years, borne little fruit. And support for development assistance has declined in many industrialized countries. But the current reassessment in some developing countries and significant progress in others provide an opportunity to make the dialogue more constructive and supportive of growth. Moreover the recent withholding of IMF funds from Brazil for failure to meet its anti-inflation target and growing pressures from high unemployment throughout Latin America indicate that the debt problem is far from resolved. The cooperation among governments and financial institutions which averted disaster in 1982 will continue to be necessary to ensure responsible action in 1985 and beyond.

Three factors most distinguish the countries which were most effective in coping with the recession and sharp increases in interest rates of 1981–1982 from those for whom it led to a major debt crisis. First, the former group of countries avoided sustained and large scale currency misalignments. Virtually all countries that encountered debt problems allowed their currencies to become dramatically overvalued. This led to an abormal increase in imports and provided an incentive for capital flight. Those who managed their economies most successfully did not permit their currencies to get far out of line with market realities for long periods of time.

Second, the best performers avoided major internal price distortions. The debt-troubled countries frequently attempted, in part through large government subsidies, to hold down prices. This led to large government budget deficits and abnormally high rates of consumption which ultimately had to be cut when austerity was imposed. The more successful countries kept these distortions in check.

Three, the best performers maintained an environment conducive to increased foreign investment. One reason for the high dependence on debt financing by many Latin American countries was their resistance to foreign investment. This also reduced the inflow of new technology and added to unemployment problems. Most East Asian countries, on the other hand, have displayed a relatively open attitude toward foreign investment.

Our goal now should be to encourage the structural and other adjustments necessary to improve the economic efficiency of some of the weaker, and debt troubled, economies. This is necessary both to reduce the possibility of a recurrence of the debt crisis and to help them become more vigorous participants in the world economy.

While trade balances in most high debt countries have improved—as the result of austerity measures, growth in the United States, and a decline in interest rates in this country—continued concern is still warranted. There are signs of growing political pressures to negotiate new repayment terms and new IMF stabilization agreements, which would create great financial uncertainty.

And the great human tragedy of famine in Africa reminds us that the miracle of the "Green Revolution" is by no means universal. New methods, new resources, and new policies in the countries themselves are required to make the necessary improvements.

It is important that a serious examination be undertaken of the results of the development process over the last 10 years—assessing the types of policies which have worked, those which have not, and how the industrialized nations can most effectively support the development process. Unless major policy improvements are made in a number of countries there will be a growing gap within the Third World between the more successful countries and those falling behind. This would harm world growth prospects and jeopardize stability in many areas.

MODERNIZING INTERNATIONAL ECONOMIC INSTITUTIONS

The major international economic institutions created in the aftermath of World War II have had to undergo major changes. Under floating exchange rates, the IMF has assumed a new but no less important role. During the debt crisis it demonstrated its ability to influence banks and governments to take the actions necessary to prevent a deterioration of the financial system. To do so it had to be given sufficient resources to provide an incentive for the country to undertake difficult adjustment measures.

But the IMF has not been as successful in influencing exchange rate movements. No framework exists for influencing national policies sufficiently to prevent serious currency misalignments. Although the Versailles and Williamsburg Summits committed governments to consult more actively to achieve greater policy convergence, and the IMF has broad surveillance responsibilities, exchange rate volatility remains essentially unchecked. If efforts are to be made to provide a framework for avoiding these problems in the future, the IMF will likely be at the center of the process. And after more than 10 years of experience with floating exchange rates, the United States and its major IMF partners need seriously to address relationships among currency misalignments, large capital flows and trade imbalances.

The World Bank and the regional development banks, which continue to play a key role in the development process also need to be examined afresh. Their role is no less important today than in the past. Because many problems of developing countries are structural in nature, long-term financing from multilateral development institutions will remain necessary supplements to their own efforts. For the very poor countries, the International Development Association (IDA) remains a vital source of concessional aid. Moreover, the resources these institutions possess strengthens their hand in providing advice regarding improvements in macro-economic policy.

It is also important to recognize the important role played by the International Finance Corporation of the World Bank. The private sector in many developing countries could benefit from increased outside support; their economies could be stimulated by the injection of new equity; and privatization of state owned enterprises could improve their efficiency. The IFC can play a key role in these areas.

Finally the General Agreement on Tariffs and Trade (GATT) is rusty and outdated. Governments frequently evade its rules. And disputes are resolved slowly if at all. As the result GATT has lost its credibility. And it is difficult to explain to an industry in one country why GATT rules prevent it from obtaining protection when it sees a similar industry in another country receiving protection through methods outside the GATT.

The trading system clearly needs an overhaul. To begin with, industrialized and developing countries must give GATT the capacity to reconcile disputes, even when these are not covered by the strict letter of international trade law. And the GATT should be in a position to insist upon and monitor domestic adjustment measures. As it develops credibility by introducing such improvements, the major trading nations can begin to negotiate reductions in the myriad distortions imposed over the last decade and resolve basic trade problems—in such areas as agriculture, investment distortions, and services—that were not successfully dealt with in previous rounds of negotiations. This is a formidable task. It may in fact be a 10-year agenda. But unless the process begins soon, frictions are likely to grow and the trading system will deteriorate further.

SOME POSSIBLE APPROACHES FOR MEETING U.S. INTERNATIONAL ECONOMIC POLICY OBJECTIVES

In conclusion, let me discuss a few ways in which our domestic and international economic policies can improve own growth prospects, our trade outlook, and the economic health of countries important to our global interests.

One answer to the dollar and trade problem, and a step toward addressing the security and arms control issues discussed above is to promote a higher rate of growth in our major trading partners. That in turn will improve our own growth prospects.

But achieving higher growth rates abroad—for reasons mentioned earlier—is easier said than done. It will require some tough decisions here and abroad. The United States can take several steps.

The most important of these is doubtless quite familiar to all of you—a reduction in our budget deficit. I do not, however, believe that such a move would quickly reduce the value of the dollar. Those who take the position that it will believe that the drop in interest rates on dollar-denominated securities that is likely to result from a cut in the deficit would drive investors into non-dollar securities.

Their argument does not give sufficient weight to two factors. One, foreign governments are likely to follow a decline in U.S. interest rates by relaxing their domestic monetary policies, and so reducing their interest rates, in order to stimulate domestic growth. Thus there would be little or no change in relative interest rates. Second, a reduction in the U.S. budget deficit would further quiet concerns about inflation in this country, thereby improving confidence in U.S. securities. Even if yields declined because of lower interest rates, the stock market would likely offer a desirable investment alternative.

But there would, in my view, be important long term benefits for the dollar and for growth abroad. By permitting others to lower interest rates without risking a sharp weakening of their currencies, the cuts in our budget deficit would facilitate growth abroad. This in turn would boost American exports and create investment opportunities in other parts of the world. That would draw capital back to Europe and other areas and strengthen foreign currencies vis-a-vis the dollar. And it would stimulate demand in a number of developing countries.

But Europe will have to make some tough decisions of its own. By lowering interest rates even without awaiting for actions in Washington, some countries might stimulate increased business activity and in so doing attract additional capital that would strengthen their currencies. It also needs resolutely to continue to reduce and remove the rigidities and barriers that have retarded market integration within Europe, increase wage flexibility, improve labor mobility and otherwise encourage the growth of investment and profitability. Japan can help by making new investments in Europe, the United States, and the developing countries, continuing steps toward market liberalization, and entering into additional technology sharing agreements with foreign corporations

The dollar problem can also be alleviated to a degree by additional issues of bonds by countries with weaker currencies in the United States or Euro-dollar market. Such borrowing, with the receipts immediately converted into yen, sterling, francs, lira or deutchmarks (depending on the issuing country) would help to strengthen these currencies vis-a-vis the dollar. It would also be a positive psychological signal to the market.

Exchange rate intervention, while hardly a panacea, can also be helpful if done in coordination with our largest economic partners and if we and they commit substantial resources to it in order to make it credible.

The industrialized and developing countries also need to devote greater attention to increasing the pace of growth in some of the weaker Third World economies. This would help to avoid a recurrence of the recent debt crisis and increase market opportunities for our exports and those of developing countries that increasingly trade with one another.

The IMF and the World Bank should continue to encourage and support structural improvement in the developing countries facing major debt and other economic problems. To do so these institutions merit strong industrialized country support. Bilateral aid, increased financing for trade credits, and new measures to encourage private investment and equity flows would further improve prospects in these countries. And we need to see the larger and more rapidly developing nations of Asia and Latin America as strong markets as well as strong competitors, and work to increase their participation in the decisionmaking processes of international economic institutions as they are also being asked to assume greater responsibility in the international economic system.

It would, of course, be counterproductive to this process if we were to erect new barriers against the exports of these countries. But the developing countries also need to see it in their interest to make commitments to lower their trade barriers both to improve the efficiency and competitiveness of their own economies and to make it politically easier for the West to avoid and ultimately lower barriers to Third World exports.

The broader trade problem also requires major U.S. leadership. We cannot afford to allow the world trading system to deteriorate. The cost to our industry and agriculture would be too high. But to effectively participate in a new negotiation we need a clear domestic concensus as to what we as a nation want to achieve. President Nixon, through the Williams Commission, drew upon the thinking of the private sector to help forge such a concensus. A similar approach can be useful today. But in the final analysis Presidential leadership, and a measure of personal involvement, will be needed both to determine the U.S. position and to convince our major trading partners to join us in making the efforts necessary for the negotiations to succeed.

As noted above, I believe the new round of negotiations should differ from those of the past in that they should start not with the task of liberalizing trade but with that of building up the effectiveness and credibility of the GATT as an institution which acts fairly and quickly to resolve disputes and permits governments to support for a time injured sectors under its rules but requires adjustment when barriers are imposed for this purpose. When the GATT gains greater respect, and confidence is built among the negotiators in the process of improving it, steps to reduce the subsidies and barriers that now distort over 50 percent of world trade can be tackled and, over time, reduced.

These negotiations will be tough for all participants, but we have risen to the occasion on previous occasions and with a clear domestic consensus on what this country wants and Presidential involvement both to obtain public support for that effort and lean on his colleagues abroad at critical points, success is certainly possible.

The United States also needs to join with countries in developing within the IMF a framework for reducing exchange rate misalignments. Because the exchange rate of the dollar feeds back—positively or negatively—on the U.S. economy, the U.S. Government has a legitimate interest in that rate. It needs to have at least a general idea of the "danger zones" that it wants to keep the dollar from entering on the grounds that the dollars entering into those zones would cause serious domestic economic and trade distortions. It should make the objective of keeping the dollar out of such zones one of the goals of domestic fiscal/monetary policy. To treat the exchange rate in a nonchalant fashion fails to recognize that—with so much of our economy exposed to foreign competition and our financial system so sensitive to capital movements—the dollar's value has a major impact on our economy and our economic policies should try where possible to see that that impact is positive.

There is good reason to believe today that the dollar's fundamental strength is based on sound market judgments, e.g. a favorable inflation outlook and good investment opportunities. But its recent surge is probably the result of a "speculative bubble" in part resulting from the market's view that the United States will not engage in coordinated intervention. While I am normally skeptical that intervention can work, we at least need a better international consensus on when to undertake intervention and how to do so effectively, and we should not give the impression of having unilaterally disarmed by repeatedly failing to use intervention when the market is extremely volatile.

Finally, we need to recognize that many of the problems before the world economy pose a major threat to our own wellbeing over the next few years. We face a dangerously large trade imbalance, a dollar exchange rate which is harmful to many sectors of our economy and distorting investment decisions, still serious growth and unemployment problems in Europe with major security implications, the legacy of a serious international debt problem that is still far from resolved, and the tragedy of hunger and poverty in many countries of Africa and other very poor nations. With our economy increasingly integrated into the world economy, each of these directly affects us.

As I stated at the outset of this testimony, we in this country have an historic opportunity. But opportunity and the wisdom to use it well are by no means the same. Our domestic economic successes can only be consolidated and their sustainability ensured if we exercise leadership in creating a healthy world economy. That objective is well within reach if we have the commitment and the vision, and if we recognize just how important to our domestic prosperity, our foreign policy and our security it is that we succeed.

The **Chairman**. Thank you very much, Mr. Hormats.

Dr. Cooper, in your statement you listed three reasons why the dollar might be as strong as it is, and discounted first of all the idea of a safe haven situation, largely because you thought European and Japanese funds were not seeking a safe haven in the classic sense. But you said there was something to the speculative bubble possibility and found that essentially macroeconomic policies were the major reason.

To what extent, if this is a speculative affair with oscillations going well beyond realities, is it likely that the dollar might come down very rapidly, and in the attempts being made now apparently by European countries in some concerted fashion to weigh in against the dollar, is this the type of activity that is likely to break the speculative bubble and lead at least to the correction of the third point that you have made?

Mr. COOPER. You raise two important points, and let me take them each up.

The skepticism which is now so widespread about the impact of official intervention in currency markets and Bob Hormats' testimony reflected a bit of that skepticism, is such that I doubt very much that intervention by central banks in Europe alone would be enough to change market sentiment dramatically. We have actually seen several episodes over the last 6 months in which major European central banks have publicly intervened in order to break the depreciation of their currencies, that is, the appreciation of the dollar, and it has an effect for a few days, but then the market overwhelms it.

So there is widespread skepticism, I think.

I do not see central bank intervention, therefore, as a triggering mechanism for a major move out of the dollar.

However, I think that it is quite possible that we could see a turn in sentiment against the dollar for other reasons, sometimes perhaps even for an irrelevant reason, something in the foreign policy field that does not bear directly on exchange markets, and once private asset holders decide that they have been adding to their dollar assets too rapidly, just a change in the rate of addition—they do not have to dump dollars—a change in the rate of addition could result in a very sharp drop in the exchange rate of the dollar.

We are borrowing at the rate of $100 billion a year, roughly, from the rest of the world. If they were to decide collectively that they would only lend $75 billion to the United States, that alone could result in a very sharp market correction.

And to the extent that what we see today is a speculative bubble, that correction could indeed come very quickly and create grave complications for our monetary authorities.

The CHAIRMAN. Some authorities have argued that this has really been the case for the last couple of years, that people have anticipated the speculative bubble might break and that macroeconomic conditions were getting worse. This is why I am intrigued that you place so little weight on the safe haven reason for why people are parking money in the United States. As you know, we have seen the reduction of interest rates, albeit maybe only 2 or 3 percent, but clearly moving in that direction, and that was the only conventional wisdom, that once they came down, so would the dollar. But precisely the opposite has obtained.

How do you explain that?

Mr. COOPER. Well, I think one has to separate the short run from the medium run. As an economist I am puzzled by the events of the period, say, September through January in which, as you point out, U.S. short-term rates came down very rapidly and yet the dollar strengthened.

However, as Bob Hormats pointed out, yields in the United States are not measured only by short-term interest rates, and during this period of time, particularly in the latter part, there was a considerable improvement in the U.S. stock market, and the U.S.

economy after the doldrums of the third quarter looks like it is doing very well. The United States remains an attractive place to invest for economic reasons, quite apart from the safe haven argument. Treasury bills are less attractive now than they were in July, but the stock market may look more attractive than it did last July. And so it is the combination of all of those things.

It is worth mentioning that although our short-term interest rates have come down a lot, they remain substantially above those of several other key countries, including Germany and Japan.

The CHAIRMAN. Dr. Feldstein, let me ask you a different question, although you may comment on the first item, too, if you wish.

You have come down very hard against the voluntary agreements for automobiles that would expire apparently at the end of March, and apparently dismiss the argument that is advanced by the Chrysler and Ford representatives in particular, and to some extent the UAW, that the strength of the dollar imposes an impossible situation. In other words, even if efficiencies have been effected by the automobile companies and by organized labor working with them that are substantial, and the rejuvenation of Chrysler in particular, and some of the Ford line, if the dollar continues to increase and as much as a 20-, 30-, or 40-percent differential comes from that factor alone, that is simply too much to bear, and in view of that, some sympathy ought to be given to a voluntary restraint if not by this country suggesting it, by the Japanese suggesting it to themselves.

What is your judgment about all of this?

Mr. FELDSTEIN. Let me comment first on the previous question that you and Dick Cooper were discussing, and then on this.

I think it is very important to bear in mind that the dollars that are coming into the United States from abroad are primarily coming into debt, not into businesses, not into equities, but are coming into debt. So the thing that is attracting them is not some abstract vigor of the American economy as a place to invest but the fact that the interest rates look good.

Now, the puzzle, as you said, is that interest rates have come down in the last half year or so. But what matters is real interest rates, interest rates in comparison to inflation expectations, and, I think, if you think back to last summer when the interest rates started coming down, that was a time when everybody was worried about the U.S. economy overheating. We had just come through the second quarter when real growth was at 10 percent, and the monetarists were assuring us we would be back to double-digit inflation by the end of the year.

I think inflation expectations have changed dramatically, and that is why interest rates have come down. But real interest rates have not come down in line with that. So I do not think there is any real puzzle to the fact that it is still attractive for foreigners to put their money here.

Now, with respect to the so-called voluntary restraints on autos, I think it is important to bear in mind that the auto companies, including Chrysler and Ford, are doing extremely well at the current time. These are not companies that are currently suffering.

Moreover, and even more importantly, while you can protect the auto companies, you can only do so by imposing more pain on others. If we protect the auto companies, that will keep the dollar stronger than it would otherwise be because there will not be the demand for Japanese cars on the part of American consumers helping to drive up the yen and drive down the dollar. So the dollar will be stronger than it would otherwise be, and that in turn means a tougher problem for agriculture, it means a tougher problem for basic industry, it is a tougher problem for high tech, for textiles, for a whole long list of other American industries.

So the question is not should we have sympathy for American industry in the context of the high dollar, but should we help autos and hurt others?

The CHAIRMAN. How would you respond to arguments that, in fact, if the Japanese exports increase substantially, that the balance of trade with Japan will be even more adverse, and second, that if we do not use this period of tension on the automobile issue to extract other concessions, we have simply missed a bet, that unilaterally we have thrown away a bet?

Mr. FELDSTEIN. If, in fact, the VRA is allowed to lapse and Japanese exports of cars to the United States go up, that will help to reduce the dollar relative to the yen, that will not deteriorate our trade balance as a whole; it will change its character. We will do less well in autos, but we will do better in agriculture, and we will do better in basic industry and in other industries that have to compete in world markets.

As far as trading this with the Japanese for something, it is not clear that taking away the current restraints would actually be hurting the Japanese. So I do not think that there really is a basis for trade with them over this issue.

The CHAIRMAN. Dr. Cooper.

Mr. COOPER. Mr. Chairman, I agree with his last point, and I would like to make it even stronger. I do not think that this has any trading value with the Japanese. The Japanese, of course, have diverse interests within the country, and there would be some companies that would welcome a relaxation of the restraint. As I understand it, we have thrown the ball to the Japanese on this issue, and it will be very interesting to see what they do with it. But on balance I would say that the voluntary restraints have benefited the Japanese at the expense of American consumers, and, therefore, it has no trading value with them.

The major Japanese companies who are already in this market like it. MITI likes it because it gives MITI some leverage over the Japanese automobile firms which they did not have before. The main losers are American consumers.

The CHAIRMAN. Thank you very much.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

I appreciate the comments and statements of our witnesses.

I would ask any one of you to comment on these issues. I may address a specific question to either one of you.

Mr. Feldstein, in the last section of your testimony you talk about the LDC debt, which is obviously a major issue, and you are a lot more optimistic about it than some are in terms of the progress that is being made. You point to the relationship between exports and the inflation rates in these countries as a very positive sign.

There was an article in the New York Times of February 26, entitled "Rekindling Is Seen of Latin Debt Crisis." Obviously there are other countries aside from Argentina, Brazil, and Mexico that face serious debt problems. That article points out that there are a couple of problems to which we must pay more attention. One, the price of oil has dropped, that that impact on Venezuela and Mexico has caused them to substantially re-alter their economic forecasting. Two, none of the agreements with the IMF have been signed. They are all waiting, apparently, to get approval from creditors before they will actually sign off on these agreements. There is concern that some of the banks may get cold feet and move away from this situation.

I do not know if you saw that article or not.

Mr. **Feldstein**. Yes.

Senator **Dodd**. Does that in any way change the optimistic conclusions you have in your testimony?

And after you respond, Bob or any of the others who would care to comment on this.

I should add another twist to this which may take up all my time, particularly one question. I realize you are here to talk about economic policy, but as Bob Hormats has pointed out, and I think all of you would agree, you cannot separate these issues. We have you here to talk about economic policy, but the political implications are profound, and I wonder if you might comment; step out of your more specific roles and talk about what you see as political implications, particularly in Latin America, which is under significant pressure in this arena, and what you see as the short- and long-term forecast in light of these events that have occurred over the last several months.

Mr. **Feldstein**. I do remain, as you said, relatively optimistic. I think the inflation problem in Latin America has certainly not been licked. Those countries have not shown the kind of resolve to deal with it that needs to be shown.

As far as oil goes, while it hurts Mexico and it hurts Venezuela, on balance the debtor countries as a whole are better off with lower oil prices because the cut in the import costs for Brazil, Argentina, and other non-oil-producing countries is greater than the losses for Mexico and Venezuela. It does mean that a Mexico and a Venezuela has to rethink the speed at which they can turn their situation around, but that basically we should not look at the fall in oil prices as a negative.

The reason for my optimism is my sense that the key issue here is exports, the ability of these countries to increase their exports and to become export oriented, to stop being inward looking, to look, as I believe they have, at the experience in Southeast Asia, and discover that the way to deal with their, not just with their debt problems, but with their own economic growth, is by increasing their exports.

It has been a painful lesson, but it has been a positive thing that has come out of all this.

It is not automatic, but they are showing themselves capable of increasing quite substantially their exports. It has involved currency realignments, it has involved pressures within their own countries to do it, but they have shown that they can increase their exports, and I think if—and there are a number of ifs in my testimony—if the world recovery continues and if, even more importantly, we do not close our doors to the exports of those countries, then I think they can have the kind of export growth that is needed both to deal with their foreign debt situation and to maintain their internal growth.

In coming to the political aspect of it, I think that is the only way that they can do it that is politically viable. They cannot cut back on imports and contract their economies to meet their foreign debt service requirements for a sustained period of time without creating a political explosion. They were able to do it for a year or a year and a half before they could start increasing exports, and that is what Mexico did, and that is what Brazil did, but since then they have turned around and they are on an export increasing economic growth path which I think is politically viable for the long pull.

Senator DODD. I would like to comment. I particularly like your idea of including in the IMF conditions foreign equity investment laws. I happen to like that. Again, obviously, you do, and I wondered if the others might comment.

I do not know if you are familiar with the comment Mr. Feldstein made.

Mr. FOWLER. I would like to comment on that. I think it is very important to stress that, and I would hope that the expansion of the operations of the International Finance Corporation, the equity arm, as it were, of the World Bank, could be sharply addressed to how that can be done.

However, I think that the other key question is, as Dr. Feldstein indicated, the maintenance of their export capability. In that connection and as a reason for I would say conditional optimism, I would like to refer you to page 23 of my statement. The Managing Director of the International Monetary Fund, de Larosiere, said in an address recently, I think it was in November in New York, that "the latest medium term projections undertaken by the fund staff suggests that by 1990 the ratio of external debt to exports of goods and services for the seven most heavily indebted countries, taken together, could fall by two-fifths while economic growth could increase to about 5 percent a year over the second half of this decade."

He then adds in his speech, and I did not include that in my paper, and I quote the following:

> That is conditioned on maintenance of the adjustment programs that have been negotiated and says that I hasten to add that while this outcome is feasible, what will actually happen will depend upon policies that are pursued. The implementation of adjustment programs by the debtor countries will have to continue.

And then a little later on he says the adjustment efforts of developing countries will need the continued support of the international community.

> The industrial countries must strive to create a better world environment. Their success in ensuring the sustainability of the recovery and bringing down interest rates and in opening their markets to developing countries' exports will be of decisive importance. At the same time, continued cooperation among financiers will be

necessary to provide the underpinnings, meaning the financial underpinnings, for the adjustment programs.

So I share Dr. Feldstein's optimism, but it is a conditional optimism based on the maintenance of the adjustment programs and the industrial democracies basically doing their part of the deal.

Mr. **Hormats**. Could I add one thought to that, and that is that on your political point, the difficulty that they will have is twofold, one, that they have over the last couple of years increased exports rather substantially, in part because the United States is growing so rapidly, but also because they have really squeezed down demand in their own countries. And the two interacting together have led to these enormous increases in exports.

But the growth in Latin America—what remains to be seen is whether when they resume relatively high rates of growth they will be able to enjoy those benefits of increased exports, or the alternatives, if the U.S. economy turns downward or simply flattens out, that big surge will also be muted.

The real question, I think, is whether they will do the structural things that de Larosiere is mentioning to make their economies more outward looking and more open, whether this is a temporary phenomenon as a result of tight demand internally and strong demand in the United States, or whether it is a more enduring phenomenon.

The other point is unemployment.

Traditionally these countries with their very high rates of population increase need a much higher rate of growth simply to keep even. We consider if we have a period of 3½ to 4 percent growth in the United States, that is wonderful, for our economy. Our population increases are relatively modest. In these countries they really, in order to absorb the already large pool of unemployed laborers and to deal with more people who are coming on stream every year, which is a social and a political as well as an economic problem, they really have to grow at a higher rate.

And one of the difficulties is that people who have been living under a period of 2 or 3 years of austerity are now saying to their governments we want more, a little more stimulus, we want to see a little more growth. And that is where this conflict will come, do these countries use the resources they earn from their exports and other resources to pay off their debts, or do they divert more of it to domestic investment and domestic consumption?

This is going to be a problem with the new elected government in Brazil. They are going to be under a lot of pressure to get the economy rolling at a more rapid rate. That is the pressures President Alfonsin is under in Argentina. It is sort of a constant problem. They have found a reasonably good balance, but there is always that tug of war, and it is going to continue until the situation normalizes.

The **Chairman**. I suspect we will need to call time at this point and recognize Senator Mathias.

Senator **Dodd**. Thank you, Mr. Chairman.

I will come back to this point.

Senator **Mathias**. I believe Senator Evans has a question, and he is under some time pressures, so I am happy to yield in his favor.

The **Chairman**. Senator Evans.

Senator EVANS. Thank you very much, Senator Mathias.

Unfortunately, I do have to get on to a luncheon. This has been a fascinating panel and has given almost consistent advice in terms of budget deficit reduction. I would like to turn to that point.

Mr. Cooper talked about reducing the Government budget deficit gradually; Mr. Fowler, about bringing it to balance or close to balance over a period of 3 years; and Dr. Feldstein, about cutting it to less than 2 percent of GNP by 1988 and the likelihood of a balanced budget by early in the next decade.

I would like to see if you can come a little closer together on what the appropriate speed of deficit reduction might be. But I would also like a comment from any or all of you as to whether or not this may even be an appropriate target.

It seems to me that we have a funny kind of bookkeeping that does not bear much resemblance to corporate bookkeeping. We do not have a separate capital budget.

Is a balanced budget given the way we keep books appropriate, or is a better focus that of the share of our national income, or the share of our Federal Government income that goes to debt service? If that share of Government income going to debt service is level or declining, even though we may have some continuing Federal deficit on the books, are we in real trouble or have we turned the corner and headed in the right direction?

I wonder whether the reduction for fiscal 1986 in excess of $50 billion is the appropriate target. I am increasingly concerned by the tendency to typefy success in deficit reduction by how many billions we have reduced. We have a lot of players in this game who are using phoney baselines, and if you have an inflated baseline, particularly an inflated baseline for national defense, you can easily or more easily get to a $50 billion reduction, but you still have not achieved very much.

And, I guess, I would like to hear more about some specific targets in terms of either percentage of gross national product or the actual dollar remaining deficit that we should strike for to claim success in 1986. Then if you could address the question of whether a budget balanced under our current bookkeeping is really the target that is necessary.

Maybe, Dr. Feldstein, we could begin with you?

Mr. FELDSTEIN. Thank you, Senator.

Well, I will, just to give you my sense of the numbers, and there is nothing certainly precise about the appropriate target, but I think as all witnesses said, it is important to get it down in a gradual, predictable way, but to make rapid enough progress so that it is clearly visible when we start to relieve ourselves of the burden of this.

I think it is very important to do so before the foreign capital inflow dries up. I think a 4-percent of GNP deficit in 1986, 2 percent in 1988 and balance in 1990 is consistent with continuing to maintain the economic recovery. It is not too fast. And yet I think it is rapid enough progress that financial markets should respond in a favorable way to doing so.

Now, as far as your more fundamental question about whether that really is an appropriate goal, there are a lot of problems with our Government accounts, and yet I think that the goal of a balanced budget is really an appropriate one.

The capital budget issue, which is something I worried about when I came into my previous job in Washington, turns out not to be terribly important. If you redo our national budget to include a capital budget, adding depreciation but taking out investment, the difference is about $10 billion. So it really does not change things very much.

Senator **Evans**. Is it worthwhile in your view, however, to do that, to embark on a changed budgetary procedure? Would it clearly set forth the difference?

Mr. **Feldstein**. I came into Washington thinking that it was, and I was persuaded that it was not, and I was persuaded that it was not because there are a lot of ambiguous lines between current spending and capital spending, and if we legitimize running deficits as long as it was for capital spending, then I think a lot of those vague lines would suddenly change, and we would find ourselves calling all kinds of pet projects capital projects in order to spend them without paying for them on a current basis.

And it is the current deficits that use up savings that would otherwise be available for investment in plant and equipment and in housing. It is not the debt service, out is the current shortfall of revenue from spending. And I think therefore that really is the thing that we ought to focus on and focus the public's attention on, and to my mind, the key reason for focusing on zero is not that zero is dramatically better than 1 percent, although I would rather have a 1-percent surplus than a 1-percent deficit, but that from a political point of view I think there still is a strong sentiment in the country that supports the notion of a balanced budget, and if we start talking about the acceptability of a 1-percent deficit or a 2-percent of GNP deficit, then the question immediately arises, well, why not 3 percent, why not 4 percent?

And I think that is a very dangerous direction to go in.

Mr. **Fowler**. I would like to respond to that. Two years ago, in discussing the international problem and the essentiality of a recovery in the industrialized countries before this committee, I tried to analyze some of the factors that I thought had given rise to the deterioration, you might say, of the international economic situation and global growth, since the mid-1970's. And one of the factors that I specifically mentioned—and I will quote from that testimony—"was increases of both national governmental expenditures and budget deficits to unprecedented levels in peacetime as a percentage of gross national product."

And then I went on to try to account for why that had happened, the well known reasons of the transfer payments increases and so on and so on.

I was interested to find that Mr. de Larosiere, the Managing Director of the International Monetary Fund, in a very interesting lecture last fall on the growth of public debt and the need for fiscal discipline, had this to say, and I quote from his text: "the debt explosion is not limited to a few countries but rather is a worldwide phenomenon. Between 1974 and 1983, the ratio of central government debt to gross national or domestic product rose sharply in most industrial countries. For the seven largest industrial countries, the so-called group of 7, that ratio rose from an unweighted average of 22 percent in 1974 to an average of 41 percent in 1983." Some of it was—and then he goes on to say it is very sharp indeed.

In Japan, for example, the ratio rose from 12 percent of GNP in 1974 to 53 percent in 1983. In Italy it rose from 45 percent to almost 79 percent. And in Canada it rose from 16 percent to 35 percent.

In the United States, the ratio remained almost unchanged at about 28 percent up to 1981. But then it began to increase sharply, reaching almost 36 percent in 1983.

Now, what it did not say was that since the end of World War II, the ratio of that Federal debt to gross national product has steadily declined from, I think—I used to present charts on this question every year to the Appropriations Committees and other committees and say it has declined from around 48 percent down to about 26 or 27 percent. And it is only with these recent larger deficits hitting at it that the ratio has bottomed out and is now back on the way up.

Now, this is perhaps an intangible psychological factor, but it is I think what is giving rise to—the notion that our budget deficit is out of control is what is giving rise to the sentiment around the United States domestically and to sentiment abroad that we are no longer in control of our fiscal situation, that the fiscal discipline that Mr. de Larosiere refers to as being terribly important, not only for the debt-ridden less developed countries, but also for the highly developed industrialized countries. And that is why getting down to a point where that ratio keeps going down makes some sense to me.

Now, whether it is zero or whether it is a $50 billion deficit in current terms may not be terribly important. I know when I was Secretary of the Treasury and I saw the budget deficit going up from $8 billion one year to $25 billion the next year, I practically wanted to jump out of the Washington Monument and commit hara kari. And we did get through in the spring of 1968 an increase in taxes and a reduction in budgetary expenditures, a combination of that package, and that produced our last surplus in the budget, July 1, 1968 to June 30, 1969.

So I think there is an intangible here about financial stability that is kind of overriding a lot of other good things that are happening that is back in the people's minds. They do not know whether we are dancing on the *Titanic* or whether this game can go on forever.

Senator EVANS. I notice that my time is up, Mr. Chairman.

I wonder if Mr. Cooper, however, could respond to the question.

The CHAIRMAN. Certainly.

Mr. COOPER. I do not think that balancing the budget is the appropriate target for the United States now or ever. It seems to me that the Federal budget is appropriately an instrument of national economic policy, and therefore we ought to design our overall balance between revenues and expenditures with the objective of economic stability and growth in mind. And if you ask me what that means concretely, like Mr. Feldstein, I think it would be desirable as a longrun objective actually to run a surplus for a while in the Federal budget in order to increase the national savings, lower long-term interest rates and so on, but I would not do that if I thought that that meant running a recession.

So it is a question of paying attention to what is happening to the economy in the meantime.

But I think balance in the Federal budget is an arbitrary target which has to be justified, if it is justified at all, on political grounds, that people cannot understand anything else, and not on intellectual grounds. I think intellectually it is the wrong target to have.

As to the question of the shifting baseline, I agree with you entirely. I deplore not only the shifting baseline that people use, but the habit I have noticed has developed in Washington of taking more than 1 year at a time, adding up 3 years, 5 years, and say we are going to save so much. If you add enough years, you can always save as much as you want, and I think there ought to be a self-imposed rule that we talk about 1 year at a time, choose the year, 1987 or 1988, or whatever it is in the discourse in question, and be absolutely clear on what the baseline is that is started, because the public is understandably confused, and confusion in this area leads to cynicism, which is unhealthy for our political system.

Senator EVANS. I thoroughly agree. I think the farther out we look, the inability to project increases geometrically, not just linearly; such projections are practically useless when we get out that far.

Thank you very much, and thank you, Mr. Chairman.

Mr. FOWLER. Mr. Chairman, I would like to add one footnote to what Dr. Cooper said.

I too would agree intellectually with him as to what the targets ought to be, but I think taking the political situation into account that not just the United States but most of the industrialized democracies, to say nothing of the lesser developed countries, are operating in an atmosphere, that politically the experience of the governors and the various states seems to me to be the only sure way of getting to real fiscal discipline in the world in which we live.

The CHAIRMAN. Thank you.

Senator Mathias.

Senator MATHIAS. Mr. Chairman, I never thought of Mr. Cooper as a Hamiltonian, but he certainly sounded like Alexander Hamilton in his last response. Hamilton once said that a national debt could be a blessing, if it is not excessive.

Mr. FOWLER. Thomas Jefferson did not want one at all. He was afraid it would become excessive.

Senator MATHIAS. Well, would you not have thought of him as more of a Jeffersonian than a Hamiltonian? [Laughter.]

I have listened with great interest to the discussion this morning, and I have heard each of you say in one way or another how optimistic you were, conditional optimism, measured optimism, moderate optimism, but I have to tell you frankly that if you ever decide to hire out as a team of crepe hangers, I will give you a score of about 8 out of 10.

And I think you are right. I think that there is a considerable cause for concern if not alarm.

One of the things that I was encouraged by was that Secretary Fowler referred to the formation of the Bretton Woods Institute——

Mr. FOWLER. Bretton Woods Committee.

Senator MATHIAS. Bretton Woods Committee, which addresses itself to the problem of a lack of understanding in the Congress of the role of the international financial institutions. And I am encouraged by that because I think the need is so great.

I do not believe we have yet emotionally faced the budget situation within the Congress. We may have faced the situation intellectually. We all know the figures. The statistics are hard to avoid, but I do not think the Congress has come to grips emotionally with the dimensions of the problem that we face.

And that is going to happen sometime in the near future. I think it is beginning to happen now. We are looking at the termination of Amtrak. We are looking at the abolition of the Eximbank. We are looking at the termination of student aid. We are looking at a long list of really draconian measures that we may be forced to take as a result of what I call debt mail, the debt so big we cannot go forward with these programs that are of national significance and importance.

And when the agony of those alternatives grips the Congress, it is going to be hard work to hold support for the international financial institutions.

So I am glad that somebody has taken on that job, and I will pledge to do whatever I can to help. But it should not be underestimated just how tough it is going to be.

One thing that has not been discussed very much in relation to the hard dollar or the high dollar is the relation of other currencies to each other, not to the dollar but to each other, the relation of the pound to the deutschmark. What is the significance of the fairly stable relationship among other countries?

Mr. FOWLER. They have instituted in recent years in Western Europe, particularly among the key countries in the European Economic Community, a kind of a financial equivalent in which most of the key member countries, except the United Kingdom, participate in the European financial exercise that is designed to keep the exchange rate relationships between the member countries of this group in some kind of controlled situation. And it is a kind of a moving target. I mean, changes are made in the relationship between the currencies, but there is, I would just simplify and say that there is a conscious effort between those countries to keep those changes at a minimum and to keep them within the general boundaries of the agreement that has been entered into.

So there is an international effort, if you will, in a geographical complex in Western Europe to try to avoid extreme exchange rate misalignments.

And that might tell us something about the future of the IMF.

Senator MATHIAS. Well, that is exactly my next question. What does it tell us?

Mr. FOWLER. I think it tells us, as I indicated in the last paragraph of my statement, that it might be time to take out the famous and worthy efforts of the Committee on Reform of the International Monetary System in 1973 and 1974, in which Secretary Shultz and Under Secretary of Monetary Affairs Paul Volcker represented the United States. That exercise was somewhat I think cut short because the oil price explosion took over and got everybody's attention, and the second amendment of the articles of agreement of the IMF did leave unsettled a number of the questions which were under consideration at that time. I simply suggested that this might be a good place to start from to see whether a re-examination would ascertain whether the present arrangements, which are pretty much—well, they certainly have not been working—are adequate or should be modified or adapted to the issues that have emerged since the mid-1970's, having to do with exchange rate policy.

Senator MATHIAS. Dr. Feldstein said, I believe, if my note is accurate, that the alternative to budget restraint would be sharply higher interest rates.

Is there another alternative which is cranking up the printing press?

Mr. FELDSTEIN. Maybe that would give you lower real interest rates for 6 months or 1 year, but I do not think that cranking up the printing press would offset the fundamentals that keep real interest rates high. Of course they would after a while give you higher inflation and therefore higher market interest rates, so you would have both a continuation of current high real interest rates and higher market—higher still market interest rates.

Senator MATHIAS. Of course, that is not a real alternative as far as I am concerned, and I am sure it is not as far as you are concerned, but there are a number of people in this country, both on the far right and on the far left, who are thinking in those terms.

Mr. FOWLER. Senator, in exhibit A to my statement, which is the report of the Committee to Fight Inflation, the latest report of that committee a few weeks ago focused very hard on the danger of a resumption of inflation in the terms we knew it back in the late 1970's by reason of the fact that there will be no other way to solve the budget deficit problem except to inflate the currency.

Senator MATHIAS. And of course, that cry is heard not only from pointy headed liberals but from very rigid conservatives who begin to sound like a reincarnation of William Jennings Bryan.

Bob, did you have a comment?

Mr. HORMATS. I think where you also hear it is people who feel that is part of the answer to the Latin American debt problem, for much the same reasons, and I think the calculus would be that you would simply get a big—if the public perceived that to be happening, that the United States, even responsible people in this Government even thought that was an option, you would see nominal interest rates just shoot through the roof. And that would be because one of the reasons interest rates are going down now—admittedly they are a problem now. One of the reasons is there is increasing credibility in this country that we are not going to turn on the monetary spigot, and if we tried to do that, I think you would get great concern over inflation and you would in effect move back to stagflation. You would have a run up in interest rates, and you would have, because of the anticipation of inflationary pressures, also a higher rate of inflation. Just the notion of that would be very harmful, much less the reality of doing it.

Mr. Cooper. I do not want to identify myself either with your far left or with your far right, but I do think what has been said both in your remarks, Senator, and so far here, leaves the Federal Reserve with too little criticism. I believe that an important part of the history of the last 4 years has been our monetary policy, and in my judgment, it has on average over this period been much too tight.

We are now in a boom period so I would not actually register that judgment at the present time, and it would take us too far afield to go into the details, but I think it is very hard to explain the high, real short-term interest rates in combination with the depth of the recession we had in 1982 without pointing a strong finger at the Federal Reserve.

I speak up now, therefore, to suggest that it would be a mistake to treat monetary policy as something that is beyond public scrutiny. It should be subject to public scrutiny, including by this body. It is not sacrosanct.

I hasten to say I am not in favor of stepping on the monetary accelerator enormously at the present time.

Senator Mathias. Well, I have harassed you all enough over the years that I do not want to do too much more today.

I did have one final question for Dr. Feldstein.

You said that an increase in Japanese defense expenditures would not materially affect the trade deficit, and I would agree with that. But suppose the Japanese were to begin tp expend large amounts in development aid to the Third World, significantly larger amounts, something which would be commensurate with what we think their contribution for world security and world stability ought to be? What would be the effect of that?

Mr. Feldstein. I would say it depends primarily on how they finance it. If they finance it by increasing their budget deficits at home, then I think it clearly would strengthen the yen and reduce their competitiveness. If not, if they simply raise taxes and use those funds to make transfers to other countries, I do not see that as having any significant effect on their grade deficit with the rest of the world.

Mr. Hormats. I think it would also depend upon whether it is tied or untied. If it is untied, then you would see some addition.

Mr. Feldstein. You get some small effect, but I think that as long as they continue to have the same net national savings at home, they are going to have the same basic trade balance with the rest of the world. The form of it may change, but the overall trade surplus of Japan has to be equal to the difference between their domestically generated savings and their domestic investment, and if that is not changed by a change in Government deficits or by some change in private saving and investment in Japan, then their trade surplus is going to remain the same.

Mr. Cooper. I agree with that analysis, but I would not want to leave the implication that it would be undesirable to press Japan to increase its foreign aid substantially, and I come back to the question raised by Senator Dodd about the political difficulties and our apparent optimism about the debt problem. I share the optimism about the major Latin American debtors, which are the ones who have received so much attention and the ones that in some sense are system threatening.

Much less visible publicly are dozens of countries, many of them in Africa, who are in desperate straits at the present time and where I think one can be much less optimistic about the political future. We are going to see a lot of political turbulence unless some form of relief is provided, and one way to provide that relief without changing the overall Japanese surplus is for Japan to give more foreign aid.

It is worth pointing out that in the budget that the Japanese Government just submitted to the Diet, they do project an increase in their external aid of 7.8 percent, which is the highest single increase of any of their budget items, other than servicing their public debt.

So they are conscious of the direction in whch they should move. That is in considerable contrast to the administration's request for bilateral economic assistance, which is down.

And while, to repeat, I do not think that will change the overall Japanese trade balance, it will nonetheless provide some help in managing the world economy through a difficult period.

Senator MATHIAS. I would agree with you that irrespective of its impact on the trade balance, it is a desirable development; it is something that ought to happen.

Mr. FELDSTEIN. I would agree with that also. I was really just trying to address in that and in my prepared statement about the defense spending whether that really is in some sense a solution to the trade problem, and it really is not.

Senator MATHIAS. Well, I have taken every opportunity I have had when the subject has come up with the Japanese, to express that view. I think it is really a more fruitful way to go than to keep pressing them to increase defense expenditures, which they continue to resist.

Mr. COOPER. They can afford to do a little bit of both.

Senator MATHIAS [presiding]. You sound more and more Hamiltonian again.

Gentlemen, the light is on for me, and I am not sure what the chairman's disposition is, but he has now returned, and so he can tell you.

The CHAIRMAN [presiding]. Thank you very much, Senator Mathias.

I apologize for all the bobbing and weaving throughout this morning, but as the panel perceives, a number of issues are being handled even as we have your testimony.

Now, let me ask just one more question of you. Yesterday Paul Volcker, Chairman of the Federal Reserve Board, was before the committee testifying on these issues, and I raised with him a question that maybe is appropriate after Dr. Cooper's comment, asking why it would not be appropriate for the Federal Reserve Board to weigh in presently to try to lower interest rates.

Given the fact that the strength of the dollar is certainly a depressant with regard to inflation, the Fed is not really left to fight that battle alone. Inflation at the moment seems to be fairly well under control. To the extent that interest rates came down, perhaps some of the pain that is now experienced by American business and farmers and others who, as all of you pointed out, are inclined to demand more protectionism, might be abated somewhat. His judgment was that that would not be an appropriate policy. If interest rates should come down for the right reasons, namely, market reasons.

Do any of you have any comment on this general thesis, that it would be a good idea if monetary policy led to lower interest rates presently, given all of the matrix of conflicting problems that come back and forth? I perceive that without there being some leeway, even though it is undesirable, protectionist sentiment could take hold. It may be undesirable but the Senate of the United States yesterday passed legislation designed to influence credit for farmers so extensively, and that may be just the forerunner of many things which have a basis in economic hurt as it is perceived in the country.

Would it not be the better part of public policy now to move toward lower interest rates and try to alleviate some of these situations?

Mr. FOWLER. Mr. Chairman, with my limited thinking and knowledge in this field, I did say in my statement, in talking about the importance of having an adopted credible Federal program to move the Federal budget deficit down over a 3-year or 4-year span to something approaching equilibrium—let's put it that way—I did say that this program should be spaced over a 3-year span. That should minimize the risk of a sudden preemptory withdrawal of tremendous fiscal stimulus from the existing deficit.

It will also give monetary policy an opportunity to take advantage in orderly fashion of a better balance of fiscal and monetary retraint, to encourage lower interest rates, without risking an inflationary surge.

What was behind that statement is the feeling that I would have, that if the Fed were known to be trying to provide lower interest rates, there would be a feeling around—at least I will speak for myself, though I think it reflects a certain amount of opinion around—that we have reduced taxes which were in a very stimulated, and successfully stimulated fashion.

And the budget deficit is increasing, and that is a continuing pouring on, shall we say, stimulus into the economy. Then, if the Federal Reserve, in the light of both of those situations having occurred, announced or indicated or signaled in some fashion that it was on a drive for reducing interest rates as a national policy, I think the expectations of a rising inflation would be temporary to be sure, to be followed, as Dr. Feldstein said, not very long by a recession. Therefore a more balanced policy of fiscal and monetary restraint which we can only get by reducing this Federal deficit seems to me to underscore its importance, not only in and of its own self, but as giving the Feds some play room in which to deal with the interest rate decline.

The CHAIRMAN. Dr. Cooper.

Mr. COOPER. I said, perhaps while you were out of the room, that I thought that monetary policy was much too tight during the last 4 years.

The CHAIRMAN. Yes; I heard that.

Mr. **Cooper**. But I think it is worth noting that the interest rates that the Federal Reserve can control are largely at the short end of the market. The market then determines what the long-term interest rates are, given the short-term interest rates.

Over the last 6 months, short-term interest rates have fallen substantially. The long-term market has responded, but in a very muted way, to that sharp reduction in short-term rates, and I am not sure at the present time how much additional influence the Federal Reserve would have on the interest rates that affect most debtors—mortgage rates, long-term bond rates, and so forth at the present time.

I do believe that the Fed has a little room now in terms of inflationary expectations. It has established a record of credibility and therefore has a little scope for easing up without suddenly triggering a rapid change in expectations. But I think it continues to have to worry about that problem, and I am just not sure how much influence it could have on long-term rates without really stepping on the accelerator and triggering a revival of inflationary expectations.

Mr. **Feldstein**. I think the Fed's policy is currently correct. I think that to increase substantially the rate of money growth in an attempt to bring down interest rates would be conterproductive. I think long rates would move up because the market is continually inflation-nervous, and would see an easing of monetary policy, correctly, as a prelude to higher inflation in the future, and that would just move up long rates right away.

I think the best thing to do is to press on the key cause of this, and that is the large deficit.

The **Chairman**. Mr. Hormats, let me ask one final question of you. If there is to be a new round of trade negotiations, and you have mentioned possible formats in which that might occur, what should be our goals and what new market access do you suspect our trading partners will seek from us? What demands will be made upon us?

Mr. **Hormats**. It seems to me our initial goal is to make sure that the system itself is a proper instrument for resolving trade disputes so you don't have to deal with the big issues bilaterally, which is really what has occurred over the last several years—bilateral agreement with Japan on autos; we have movement toward bilateral agreements to restrain or to open up trade with a lot of countries.

Well, this really is something that we learned during the period of the 1930's and 1920's is not a particularly good idea because what might be good in a bilateral context between two countries discriminates against a third country.

We bitterly resisted what was called imperial preferences. We did not like all sorts of deals that were made in Asia, bilateral deals, in the 1930's between Japan and other Asian countries. In other words, anything that really restricts trade to a few countries discriminates against trade in a global sense.

So, to move toward these sorts of bilateral things is not particularly helpful from a systemic point of view and, in the long run, not healthy for the world economy.

I think our basic objective ought to be, one, to make sure that there is an efficient system of resolving disputes quickly in the GATT; two, to ensure that the GATT or some GATT-related institution has the ability to insist that when restrictions are applied for temporary periods, as governments will do and from time to time need to do, there should at least be an adjustment mechanism that goes along with those so that they can be phased out over a period of time.

And I think labor and business in the United States agree that some adjustment-related mechanism that goes with protection is a good idea to be sure that whatever protection is applied can be reduced over a period of time.

Three, there is still a lot of barriers in three areas: one, agriculture. The last two negotiations really did not deal with the barriers and subsidies which proliferate world agriculture.

There is also the problem that we have been discussing: services. We are very competitive in services. Britain is. A couple of other countries are. Yet, there are lots of barriers in services. If other countries expect us to open up in areas that are important to them, we who are competitive in a lot of the areas of the service sector should get openness in terms of their markets.

There are a lot of trade investment-related restrictions. By that I mean questions of whether certain countries subsidize investment, and by subsidizing investment they are in effect distorting trade as a result.

These are the sorts of things that are fairly significant items, indeed very significant items. There are a lot of other restrictions that have been posed over the last several years, subsidies in a variety of sectors. The problem is today, free trade is more a myth than a reality because so many governments have intervened in so many ways to help given sectors of their economy.

Now, there are going to be tradeoffs. I mean if it is really to be a negotiation, we are going to have to give if we are going to get. And that is where the pain occurs. Suppose, for instance, you go to country X and say we would like to have our banks or our insurance companies be able to do business there on the same basis as your national banks or insurance companies. They will say all right; you are efficient in banking and insurance; we would like to sell you more of our textiles or steel.

That is an awfully difficult tradeoff. I am putting it in stark terms, but those are the sorts of tradeoffs we are going to have to be aware of.

Let's suppose you go to a country, keeping it in the service sector, and say we would like to have our lawyers be able to practice in your country freely. We have proficient lawyers, a lot of them here; we would like to have them practice law or open their firms in your country. They will say OK, we will do that; we would like to have our construction companies operate in your country with our labor.

Those are the sorts of tradeoffs there are going to be. Now, admittedly, it probably will not be put in those terms, but here is the problem. In the past when we have negotiated tariffs, you develop a formula, and you apply the formula, they apply the formula, it looks relatively balanced. That was one of the big issues prior to the Tokyo round, what the tariff-cutting formula would be.

When you get into nontariff barriers, other subsidies, it is awfully hard to identify a balance between your concessions and my concessions. So as a result, this is going to mean extraordinarily difficult negotiation. It will be much harder than any we have had in the past.

And that is why I think that while it is all well and good to say what we want—and we want a lot, and we should try to get a lot—we are also going to have to come to the point where we have to determine what we are going to give to get it. And that is going to be very difficult.

Where we have some of the traditional sectors, such as steel, suffering from a lot of competition already, it will be a very reasonable argument for them to say we don't want any more. We don't want you to give anything in our sector.

The agricultural sector with all the problems it is having is certainly not going to want to give up in certain areas, although I think agriculture should get more than it gives in the next round of negotiations anyway in terms of opening up other foreign markets, nonetheless, because it hasn't gotten much in the past.

But these are the sorts of issues that I think will be very important and that is why I think that the Williams Commission idea—I don't like substituting procedure for substance because in Washington everyone tends to do that. It is a relatively easy way out. But at this point in time, it seems to me to get that national consensus, we have to do something like that.

And I know Bill Brock thinks the idea is a reasonable one, but there are certain obstacles around town. But I would like to do that. I don't know where we are going to come down. It is very hard, prior to a negotiation, to know exactly where the final deal will be struck, but somehow if we don't do it, given the fact that we are exporting more and that we are more dependent on the world economy, we will find the whole thing closing in on us.

So we have to do it soon. If we don't, we will find more and more of these barriers being erected, and we will be way behind the power curve.

The CHAIRMAN. Thank you very much.

Gentlemen, let me ask you if you would be willing to answer questions from members who are not present today, but who will submit in writing, questions to you. We would appreciate that very much for the record before we complete it.

[All four witnesses nod yes.]

The CHAIRMAN. I want to express the appreciation of all members of this committee to each one of you for the investment you have made in excellent papers and in your forthcoming responses to our questions this morning.

This hearing is adjourned.

[Whereupon, at 12:35 p.m., the committee adjourned, to reconvene at 9:30 a.m., Wednesday, March 6, 1985.]

THE UNITED STATES IN A GLOBAL ECONOMY

WEDNESDAY, MARCH 6, 1985

United States Senate,
Committee on Foreign Relations,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar (chairman of the committee) presiding.

Present: Senators Lugar, Mathias, Murkowski, Evans, Zorinsky, Cranston, Dodd, and Kerry.

The Chairman. This hearing of the Senate Foreign Relations Committee is called to order.

The Chair will mention at the outset that we will hear very shortly from William E. Brock, U.S. Trade Representative. Then the hearing will be recessed at about 10:35 or thereabouts in order that Senators may participate in a joint congressional session that will hear the Prime Minister of Italy.

Following the Prime Minister's address, we will commence again and get underway at noontime with a panel that will include Mr. Dwayne Andreas, Mr. Robert V. Roosa, and Mr. Alexander B. Trowbridge.

We are very hopeful that the panelists, guests of the committee, the press and all will be cooperative in this unusual arrangement occasioned by the leadership request that we attend the Prime Minister's speech.

Today is the third day of committee hearings on the global economy. Economic relations between the United States and many countries have developed to the point that they rival our political relationships. This is particularly true with regard to our relations with the peoples of the western Pacific region. We have heard from experts on monetary affairs. Today we turn our attention to trade.

The committee welcomes Ambassador William Brock.

The late financier and adviser to Presidents, Bernard Baruch, used to say, "When the market is on the front page of the newspaper, that is the time to sell." International trade is on the front pages of the newspaper, and the news is not good. "Imports Overwhelm Surge in Exports" shouted one headline last week.

The numbers are not encouraging. Last year our overall trade deficit with the world was an astounding $123 billion, roughly double the previous record set only 1 year earlier.

Our deficit with Japan is equally unsettling. For the past 5 years our exports to Japan have been stagnant while our imports have almost doubled, from $30 to $59 billion. Reversing these trends will be a major concern of this Congress.

In his initial address, President Reagan proposed a new round of trade negotiations as a solution to the problems of world trade. He repeated his pledge to seek a new round at his February 21 news conference and in last Friday's auto import announcement.

I am generally in accord with his goal, and hope that if the Congress should grant this authority, the administration will pledge to tackle seriously the problem of our trading partners' agricultural subsidies which are injuring our farmers' markets in third countries.

However, I would note that the last time the executive sought negotiating authority it took 2 years of intense discussions and a postelection session of Congress before agreement was reached, and it was easier to be a free trader when the trade deficit was $3 billion, as it was in 1973, than when it is $123 billion, as it is now.

While we look forward to the gains which a new round of trade negotiations would bring, Congress would look even closer at what we give up than it did 12 years ago. In the final analysis, what may hold the new round hostage is the Japanese trading system and its effects on both the United States and world trading patterns.

We are all familiar with the level of manufactured imports from Japan, autos, steel, textiles, and now telecommunications. Of itself, this would be enough to cause a great deal of concern in this Congress. What is building on this concern, however, and leading to new heights of frustration is the widespread conclusion that Japanese markets are closed to manufactured imports for all practical purposes.

A comparison of Japan's manufactured imports before the last multilateral trade negotiations in 1979 and 1983, 5 years later, shows a familiar pattern. The terms of trade, imports as a percent of total trade, have turned against all of Japan's trading partners.

No one can export manufactured goods to Japan, not the United States, not the EC, not the Canadians, not the OECD countries as a group, and not the LDC's, and certainly not the world in total. It is no wonder that the last round of trade negotiations was called the Tokyo Round.

Ambassador Brock, you have done us an important service by bringing to our attention a different aspect of the closed Japanese market. According to GATT statistics, the United States has increased its burden of manufactured imports from the LDC's from 45 percent in 1979 to 58 percent in 1983.

Japan has reduced its burden by an equivalent amount. In effect, Japan has passed the economic baton to us, to add to our already heavy defense burden. As a practical matter, this means that a steel worker in Gary, IN, may lose his job because Korean steel cannot break into its natural market.

This additional burden of import competition over what they might ordinarily have had to face may just be enough to push some steel, textile, and footwear firms into bankruptcy.

We look forward to hearing your examination of America's role in the global economy, and in particular how we can best contribute to stimulating and sustaining global economic growth as well as what you view to be the most serious impediments to such growth at present.

I normally at this point would turn to the distinguished ranking member, Senator Pell. He may have an opening comment when he arrives, but I would like to recognize the distinguished chairman of the subcommittee that has sponsored these hearings, Senator Mathias, for an opening comment if he has one.

Senator **Mathias**. Mr. Chairman, I think you have pretty well covered the waterfront. One of the happy things about having Ambassador Brock with us this morning is that he is a veteran not only of the trade battles but of the legislative skirmishes, and so we really do not need to start out by lecturing him very extensively on what is happening here.

I think he is well aware that there is a rising tide of sentiment which favors protectionism, that the unprecedented trade and current accounts deficits are triggering all sorts of emotions. It might be useful to recall Paul Volcker's statement last week before the committee that a lasting solution to the problem of external imbalances rests on simultaneously restoring internal financial equilibrium.

He said, "I know of no approach to the problem that promises success other than straightforward measures to reduce the budget deficit over time." I know from long acquaintance with Ambassador Brock that he shares these concerns and these fears.

The sentiment for protectionism in its myriad forms, not just straight, old-fashioned Smoot-Hawley, but in new and more subtle forms, has very profound implications for our whole economic scene. It is complicating the job of getting the deficit under control and ultimately reducing the debt and the debt service burden.

So, I am confident that he will give us some thoughtful advice, and hopefully point the way to some solutions.

Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Mathias.

Ambassador Brock, would you proceed with your testimony?

STATEMENT OF HON. WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

Ambassador **Brock**. Thank you, Mr. Chairman.

I will try to shorten an extensive formal statement and summarize as best I can. Let me began by thanking you for the hearing. I really am delighted to be here. The committee's emphasis on the global economic dimension of foreign policy is fundamentally important.

I recall when I told the President-elect in November 1980 of my interest in this particular responsibility. I said that it was my belief that a successful international economic policy was going to have more to do with the kind of world our children are going to live in than almost anything else, including the efforts of all the diplomats put together.

Whether or not the world economy returns to a path of sustained growth over the next several years is a question of critical importance for at least three reasons.

First, the economic welfare and political and social stability of many foreign countries increasingly depend on the successful resolution of the problems adversely affecting the world economy.

Senator MURKOWSKI. I wonder if the Ambassador could speak a little closer to the microphone. It is a little difficult for me to hear.

The CHAIRMAN. Yes, please do.

Ambassador BROCK. I at times tend to speak a little low anyway.

Senator MATHIAS. Let me say that when Senator Mansfield was majority leader, it was always a sort of double entendre to say "Keep the Mike close." [Laughter.]

Ambassador BROCK. Second, the continued failure of numerous countries to adjust to the many changes in the world economy could further limit growth and pose additional problems for the formulation and implementation of U.S. foreign policy.

And third, though the U.S. economy has been exceptionally strong and the outlook for this year bright, in the longer term even the United States can only reach its fullest economic potential in a world of open markets and robust economic growth.

Outside of the United States and Canada, the world economic recovery has been moderate to poor in comparison with past experience. Japan's 4.4 percent annual GNP growth rates in 1983 and 1984 were good, but moderate for Japan. Europe managed no better than an annual average of 1.8 percent over 2 years.

On average, the LDC's were growing at a 2.3-percent rate, but the Latin countries, where debt problems are particularly severe, GNP actually declined 2.3 percent in 1983 and grew by only 1 percent last year.

I think it is important to note that trade has historically proven a principal engine of growth. This was true in free trade in Western Europe in the second half of the 19th century, help spread the industrial revolution. This was true after World War II, when U.S.-led trade revitalization resulted in rapid growth.

Between 1953 and 1973, world GNP was up 5 percent per annum, but world exports were up 15 percent per annum and was the primary cause of the GNP improvement. Trade encourages investment in the most efficient industries with the highest productivity and wages, thereby stimulating domestic and world growth.

In the late 1960's resistance to open markets began to grow in industrial countries. By the early 1970's, world growth began to slow down and inflation began to rise. Still trade promoted growth. Between 1973 and 1979, world goods production was up 3.5 percent per annum.

World exports were up 4.5 percent per annum, despite the effect of the energy embargo and price escalation of those years.

Retarded by economic crisis and rising protectionist barriers, world trade did not grow at all between 1979 and the first half of 1983. So, restoring trade growth is a necessary part of the solution to global economic problems currently facing us.

Restoring trade growth is even more important than in the past, because the world economy is more integrated. Exports as a share of goods production rose from 14 percent in 1970 to over 20 percent 10 years later for us; from 22 to 36 percent for Japan; from 25 percent to 40 percent for France; and 37 percent to 54 percent for Germany.

Signs of problems developing in the world economy go back to the late 1960's, Mr. Chairman, when inflation rates began to rise and resistance increased to imports in a number of basic and consumer goods industries.

The underlying problem continued to build through the 1970's. The basic problem was frankly an increased avoidance of the need to adjust to changing economic conditions in the global economy.

The negative effects of increased rigidity in structures of national economic life were compouned by an often excessive and misguided extension of Government influence over the workings of markets. Some LDC's promoted investment and exports behind massive trade barriers.

Growth and trade expansion did take place for them, but at the high cost of resource misallocation. They borrowed foreign credit for projects which would sometimes never have adequate payback. Trade restrictions and excessive economic interference by governments reduced growth potential of industrial countries as well.

Excessive monetary growth was increasingly used in order to restimulate growth. Problems were worse in Western Europe, but existed even for Japan, which wasted resources by promoting industries like aluminum and civil aircraft and restricting imports in areas like agriculture.

By 1979, problems of structural rigidity, increasing trade restriction, massive inflation-related growth of debt had come home to roost. Two oil crises followed rather than preceded excessive growth of world liquidity and rising waves of inflation, and were as much symptoms as causes of the deteriorating economic environment.

Problems still remain. Protectionist barriers have not been rolled back. World economic growth has not been fully restored. Debt still hangs heavy on a number of LDC's. Our own farmers remain in serious difficulty because of their massive borrowing in the 1970's and the collapse of world commodity prices, and because of land prices rapidly falling, and frankly, the poor export markets themselves.

Looking at where we are now, long-term agricultural problems have made the normal transmission belt of world recovery through trade falter. Normally the $80 billion deterioration in the U.S. trade deficit would have ignited investment-led world recovery. Why not this time?

I think because of market rigidities and the heavy hand of government, especially in Europe, and market uncertainties for investors abroad resulting in high levels of trade protection. Global recovery then depends, however, on restarting trade and growth as engines of progress.

There are some signs of improvement. There is a greater understanding by governments of the need to allow markets to work efficiently and to encourage economic flexibility, especially in the labor markets of Europe.

Europe may grow 2 or 3 percent this year with unemployment at least stabilizing. World trade, despite the negative factors, grew by 9 percent last year and perhaps 6 percent or more this year. If sustained, trade growth will eventually stimulate stronger world recovery.

The high debt LDC's have moved from large trade deficits to surpluses. If a gradual global recovery can be sustained, they are better poised to participate.

And finally, steps to multilateral trade negotiations have for the moment been kept on track. Let me look at the global economic circumstance and the U.S. contribution to it. I think the first question is, what do we do about our own problems, to clean up our own house, as Paul Volcker addressed?

The United States cannot singlehandedly move the world on to a more healthy growth path, but we can help. To do that, we have to look to our own domestic environment first. The first part of that package is a reduction in Federal spending and deficits.

The second part is significant tax change to raise the domestic savings rate and increase the level of incentives and opportunities for savings and investment. This would lay the ground for a reduction in foreign borrowing by the United States and for a reduction in the trade deficit.

During the first 1½ to 2 years of recovery, capital inflows were beneficial to the United States, reducing our interest rates and inflation rates and financing a stronger recovery than we could otherwise have afforded.

The associated trade deficit did aid foreign economies. The U.S. deficit now has outlived its usefulness, and should be brought down. U.S. industries are being hurt even more by the trade deficit as U.S. growth slows to a more sustainable level, and ongoing accumulation of foreign debt is not in our long-term interest.

Also, some recovery of growth and investment in Europe and international payment adjustment in LDC's means these countries are in a better position to use more of their domestic savings at home.

In terms of the international obligations of this country as the leader of the free world and the industrial world, as a part of the package of measures, we also need to address the long-term structural problems retarding foreign growth and limiting attractiveness of investment abroad.

The U.S. example is having a significant impact. The principal tool at our disposal, however, is in the area of foreign trade policy. Individual economies will perform better and trade expansion can again stimulate growth if we make a substantial effort to reduce barriers to world trade worldwide.

We are trying, as the principal international priority of this administration, as the President said in his State of the Union Message, to encourage our trading partners to begin a new round of trade negotiations in the GATT this year.

That new round should include a rollback of recent barriers, the protection of our high tech and service industries against increasing tendencies of government to intervene in the marketplace, an enhancement of intellectual property rights, access to the Japanese market, agricultural subsidies and dumping practices which are enormously disruptive of world trade, a better understanding among the developing countries of adjustment requirements, and on the part of the LDC's their investment restraints, and frankly and most fundamentally, an improved operation of the GATT.

Let me just conclude, Mr. Chairman, with a two-sentence summary.

I view the present situation in fairly straightforward terms. The first and most important objective for this Government must be to clean up our own problems here in this country, and that implies a major attack on the Federal deficit this year, not next year, this year. It is the most important single act that Congress can take to deal with the trade problems.

Second, a significant reshaping of our tax system to increase the incentives for savings effort and investment. Internationally the United States simply has to assume the leadership role of beginning a new round of trade negotiations. No other country can do it. We have the capacity for leadership, and we have to exercise that capacity effectively to begin that process again this year, not next year, but this year.

[Ambassador Brock's prepared statement follows:]

Statement of Ambassador William E. Brock

United States Trade Representative

Before the Foreign Relations Committee
United States Senate

March 6, 1985

"U.S. Trade Policy and the Medium Term Outlook for the World Economy"

Introduction

I am pleased to participate in this series of hearings on the future of American foreign policy and commend the Committee for the emphasis being placed on the global economic dimension of U.S. foreign policy. Whether or not the world economy returns to a path of sustained growth over the next several years is a question of critical importance for at least three reasons. First, the economic welfare and political and social stability of many foreign countries increasingly depend on the successful resolution of the problems adversely affecting the world economy. Second, the continued failure of numerous countries to adjust to the many changes in the world economy could further limit growth and pose additional problems for the formulation and implementation of U.S. foreign policy. And third, though U.S. economic recovery has been exceptionally strong and the outlook for this year bright, in the longer term, even America can only reach its fullest economic potential in a world of open markets and robust economic growth.

The world economy is at a critical juncture. Economic activity abroad remains exceptionally weak in comparison with similar stages of previous post-War business cycles. Much of the economic growth which has taken place abroad has been stimulated by the U.S. recovery. The policies now being formulated and pursued here and abroad will greatly influence the extent to which the health and dynamism of the world economy can be restored in the years to come. In their domestic economic policies, our foreign trade partners have many problems to resolve, and our ability to influence them toward an appropriate course rests principally in the example of our own economic success. The areas where the United States has more direct influence on the performance of the world economy are in our international trade and financial policies and in the U.S. domestic macroeconomic policies which help shape our economic interaction with other countries.

Today, I would like to discuss with you the role of trade in general and U.S. foreign trade policy in particular in helping to restore the health of the world economy. With strong domestic concern over a U.S. trade deficit which may reach $140 to $160 billion this year and serious questions hanging over the outlook for the world economy, no time could be more appropriate to address the question of trade and growth. I will, therefore, briefly review with you the role of trade in promoting economic growth, the origins of recent global stagnation, the dimensions of the global economic situation as it stands today and the package of trade and related U.S. domestic economic policies I believe would both help ease our trade deficit and stimulate stronger world recovery.

Trade and Growth

If we care about the outlook for the global economy, we must be concerned about the state of world trade and the barriers which hinder its expansion. This is so because historical experience has shown that trade expansion is one of the most powerful engines of world growth we know. This was true in the latter half of the nineteenth century when the establishment of free trade in Europe helped spread the industrial revolution and resulted in unprecedented economic growth on the old continent. This was true again after the second world war when trade liberalization led by the United States encouraged an explosive increase in economic growth and prosperity. In the twenty years from 1953 to the 1973, world gross national product grew at a strong average rate of 5 percent per annum. Stimulating this strong growth in output was the even stronger expansion of world merchandise exports, at an average rate of 15 percent per year.

In every country trade liberalization and the rapid growth of exports tended to pull scarce investment capital and labor into those industries which produced for export. Because exports principally grew in industries where nations had the greatest competitive advantage in world markets, trade expansion resulted in better use of investment capital and the creation of jobs at the higher end of the national wage and productivity spectrum. Rapid trade expansion greatly improved domestic and world economic efficiency. Rising incomes and business confidence in future growth led to strong saving and investment in the new technologies, plant and equipment needed to sustain growth.

Even the increasing resistance to open trade beginning in the late 1960s and the slow down in world growth beginning in the early 1970s did not break the link between trade and growth. Between 1973 and 1979 world goods production rose at an average annual compound rate of 3 1/2 percent still led by world exports growing at a rate of 4 1/2 percent per year. After 1979, however, trade as the engine of growth faltered. Retarded by economic crisis and rising protective barriers, world trade did not grow at all between 1979 and the first half of 1983. And restoring substantial and sustained growth in world trade has become a necessary part of the solution to current global economic problems.

If anything, restoring trade growth is even more important today than it was 20 or 30 years ago. The faster growth of trade than production over the years has tended to increase the interdependence and integration of the world economy. U.S. exports of goods and services, for example, rose from 5 percent of gross domestic product in 1960 to 10 percent in 1981. For other OECD countries the corresponding shares rose from an average of 19 to 26 percent during the same period. Looking at just merchandise exports, these rose from 14.3 percent of U.S. goods production in 1970 to 28.7 percent in 1980. The increase was even more startling abroad, from 22.1 to 36.3 percent for Japan, 24.9 to 43.8 percent for France and 37.2 to 54.4 percent for Germany. Exports and imports have thus become far more densely embroidered in the fabric of our economies. When world trade booms, our economies feel more stimulation, when it stagnates the depressive effect on domestic performance is greater.

Origins of Current Global Economic Slowdown

Experts are still debating the causes of slowdown in the world economy and trade. By the late 1960s there were visible signs such as, rising inflation and resistance to increasing imports in a number of basic and consumer goods industries. Fundamental problems continued to develop somewhat below the surface of observed economic performance until finally coming fully home to roost at the end of the 1970s. The oil crisis of 1979/80 and the need to break the world inflationary spiral which it aggravated resulted in several years of world wide recession. With recession and mounting unemployment came increased pressures for trade protection and a substantial increase in actual barriers. With attempts to wring inflation out of the system came crisis for those who had borrowed massively in the previous decade, including a substantial number of developing countries and at home, some banks, businesses and households. Nor have these problems been fully resolved. Protectionist barriers have not yet been rolled back; world economic growth has not fully recovered; despite significant progress debt still hangs heavily on the prospects of a number of LDCs, particularly in Latin America; and at home the much publicized plight of our farmers under pressures of massive debt, disinflation of commodity and land prices, and poor export markets. Such factors suggest that the recuperative process of the world economy is not yet complete.

How did the global economy reach such a state? Obviously the causes are many. One broad category, however, I feel covers much of what went wrong. I would characterize the fundamental problem as an increasing tendency in many economies to refuse the need to adjust to economic change, an increased rigidity in the structures of national economic life. This structural rigidity affected both foreign trade and domestic economic performance. On the trade side, some, but not all, of the LDCs which switched to export-promoting policies in the 1960s and 1970s did so behind substantial barriers to imports and subsidies and other trade-distorting policies applied to exports. Growth and trade expansion did take place for them, but often at costs made too high by the underlying misallocation of domestic resources. Foreign credit was borrowed for investment projects which would never have an adequate payback.

For the industrial countries, structural rigidity also meant increasing restrictions on imports and subsidization of exports. Imports were frequently resisted on the grounds of unfair trade practices by the producing country. Sometimes unfair trade practices were involved, other times not; frequently the stronger motivation for import restriction was to avoid the pressures for domestic adjustment generated by competitively priced imports. Adoption of advanced automation techniques to meet the competition was expensive for firms and raised employment problems as fewer production workers were required. As more markets closed to imports, the markets which did remain open were put under sometimes unbearable pressure as exports were diverted toward them. The steel trade problems of the United States is a characteristic example of this process. On the export side, some governments heavily subsidized production behind trade barriers to restructure an industry or gain new competitive advantage in a targeted industry. Too often the result was the waste of scarce national resources and the maintenance of employment in particular industries at levels which could not be sustained under more open competition.

On the domestic policy front for industrial nations, increasing trade protection was a drag on economic growth. Excessive and sometimes misguided government regulation of economic activity built further distortions into national economies and reduced growth potential. Rapid monetary creation was resorted to in order to restimulate growth as well as to finance the part of exploding social expenditures which even rapid tax increases could not cover. Two oil crises punctuated this period of deteriorating economic environment, but significantly they followed, rather than preceded rapid increases in global liquidity and rising waves of inflation and were as much symptoms as causes of the deteriorating economic environment. In some countries, of course, the structural rigidities and the problems they engendered were greater than in others. No industrial country, however, seems to have escaped the general trend. Among the industrial countries, the problems have grown deepest in western Europe. But even Japan over the last decade managed to waste scarce national resources in unsuccessful attempts to subsidize competitive industries into existence in areas such as civil aircraft and aluminum. Its restraints on import competition, perhaps most blatant in the area of agriculture, have handicapped their efforts to narrow the 30 percent advantage the United States still enjoys over Japan in average labor productivity.

Where We Now Stand

I have emphasized the longer term, structural nature of the current crisis in global economic performance because there is a tendency to attribute too large a part of current problems to shorter term macroeconomic factors. For instance, the charge has been heard that recent high U.S. interest rates have prevented the European economies from attaining a vigorous recovery.
Neither high interest rates nor a massive deterioration of the

U.S. trade account, however, prevented America from realizing an exceptionally strong recovery, and Europe's problems are, in fact, far deeper than the cost of credit.

At the macroeconomic level one development does stand out. On earlier occasions the type of stimulation provided to the rest of the world by the $80 billion dollar increase in U.S. net imports over the last two years would have ignited a strong world recovery. The follow-on foreign recovery would have been led by increased investment abroad in industries stimulated by booming exports. This strong foreign investment, however, has not taken place this time around and foreign recoveries have been weak relative to past experience.

This so-called transmission belt of global recovery has stalled apparently for several reasons. Foreign firms have generally failed to undertake the normal step up in trade-related investment because of cumulative structural rigidities, especially in Europe where unemployment has grown every year since 1973 and is now over 11 percent, and because of uncertainties over foreign market access created by the now high level protectionist trade barriers. The resultant sluggish rate of industrial country growth has limited demand for LDC exports and kept commodity prices unusually depressed thus retarding international payments adjustment and growth in a number of developing countries. The United States is thus left, in the popular phrase, as the only game in town.

The result is foreign capital eager to reach our shores for investment in a U.S. economic boom which is itself highly dependent on foreign borrowing. Our own recovery reflects the greater innate flexibility of our economy and the many sound economic policy adjustments made over the last several years ranging from industry deregulation to reductions in Federal taxes and spending to anti-inflationary monetary policy. Our economic interests in the longer run, however, are no more served by the unbalanced nature of the current world recovery than are those of our trading partners.

Despite the continued existence of the problems plaguing the global economy, I do see some signs for hope of an improvement of the situation, particularly if supported by a number of corrective actions. First and foremost, I would emphasize the fact that there is increasing understanding of the nature of the adjustment problems the world economy faces. Britain, for example, is several years into efforts to lessen government control of economic activity and to encourage efficient market allocations of that nation's productive resources. The American market approach and success are even back in fashion in France where efforts to provide greater scope for private entrepreneurship and flexibility in labor markets are under way. Guarded optimism seems to be developing for European economic performance this year perhaps rising in the 2 to 3 percent range from last year's 1 to 2 percent and with unemployment at least stabilizing.

World trade did begin to grow again in the second half of 1983, expanding by a sizable 9 percent last year and increasing by perhaps 6 percent this year. U.S. imports provided a large part of the impetus. We have not yet seen strong positive effects on world growth, but if we can build on this success with a sustained expansion of world trade, the chances will increase for restarting traditional engine of trade and growth.

The growth of world trade and especially U.S. imports has made a substantial contribution to the adjustment of the high-debt LDCs over the last two years. Many have swung from large trade deficits two years ago to larger trade surpluses, thus building foreign exchange earnings and strengthening their international financial positions. Unfortunately, much of the progress has been made by restricting imports rather than expanding exports which has limited their economic growth potential. Nevertheless, they are better poised today to participate in future growth and trade expansion if the still fragile global recovery can be nurtured and extended.

A last area of guarded optimism is the partial success we have had in keeping the world trading system on track for a major assault on the trade barriers which have so negatively effected global economic performance. While only limited progress has been made on industrial country commitments to rollback the build up of protectionist barriers over the last several years, we are coming closer to agreement on a major new round of multilateral trade negotiations within the GATT. The current GATT work program serves as a basis from which negotiating issues will be drawn. We seek to get preparatory discussions for a new round underway by midyear. Although success is by no means assured, the necessary international consensus could be developed by year's end for such a round to begin.

What Can We Do To Encourage World Recovery? Domestic Policy

The United States cannot singlehandedly move the world on to a more healthy growth path. Too much needs to be done at the level of domestic policy in lands outside our own. For example, only European governments can deal with the rigid labor practices, excessive government regulation, overly large and expensive governments, inadequate levels of investment and insufficient incentive to private entrepreneurship which have sapped the Community's economic vitality. But if we cannot do everything, we can nevertheless do much. I would like to suggest to you the elements of a package approach which I feel represents a responsible exercise of U.S. leadership to seeking improvement of the global economy.

The first element of my suggested package would most assuredly be the adoption of domestic policies to encourage a reduction in our trade deficit. Although the $80 billion increase in our foreign trade deficit over the last two years has limited the normal cyclical expansion of a number of U.S. industries competing with imports or serving foreign export markets, the trade deficit has had positive effects on foreign economies. The $23 billion improvement in Europe's trade balance with the United States over the last two years kept European economic performance from being even worse than would otherwise have been the case. The $34.3 billion improvement in the developing countries' trade balance with us over the same period contributed very significantly to the adjustment of their international payments required to service their external debt. In Latin America, what economic growth there has recently been has been largely attributable to increased U.S. imports from that region. And, the rapid growth of U.S. imports, which provided an important source of economic growth abroad, has now started to help our exports begin to recover.

On the domestic side, to evaluate the impact of our trade deficit, we must have a clear idea of the most important cause of trade deficit. Economic recovery beginning in the first quarter of 1983 led to a U.S. investment boom. In the first six quarters of the U.S. recovery, the annual rate of private investment in the United States increased by $285 billion. Private saving in the United States however did not increase sufficiently to finance this strong recovery. Private saving rose by only $160 billion. The remaining credit was obtained by a reduction in Federal, state and local budget deficits by $30 billion and even more importantly by the borrowing of $95 billion from foreign residents.

To lend to America, foreign investors must exchange their domestic currencies for dollars in exchange markets. This drives up the value of the dollar, making imports cheaper and U.S. exports less price competitive. In fact, the dollar moves to assure that what we borrow in foreign capital each year will be just matched by a corresponding absorption of real resources from the rest of the world, as measured by the deficit of trade in goods and services as measured by the current account. When all the figures are in for 1984 they are likely to show that America borrowed slightly over $100 billion from foreign residents last year and had a goods and services trade deficit of like amount. In 1983 and 1984 this foreign borrowing had its advantages because without it U.S. interest and inflation rates would have been higher and recovery most likely weaker.

I feel however that the U.S. trade deficit and corresponding foreign borrowing are losing their usefulness and that corrective steps should now be undertaken to reduce both. At home the enormous trade deficit may begin to hurt some trade sensitive industries even more severely as the economy settles into a more sustainable rate of growth than the 7 plus percent of the

the first six quarters of recovery. Just as importantly, the rapid and continued erosion of our foreign trade balance is clearly undermining U.S. public support for open market policies at a time when the world economy urgently needs a reduction in trade barriers to stimulate economic growth.

Although our foreign trade partners have benefitted from the U.S. trade deficit, we have probably reached the point where their interests would also be better served by a leveling off and decline of U.S. foreign borrowing and trade deficits. The reduction in direct stimulation they would lose on the trade side would be compensated by lower U.S. and world interest rates as America moved to supply more of its own credit needs, and depended less on exceptionally high interest rates to attract foreign capital. The now modest pickup in growth and investment abroad as well as the easing of international payments constraints for a number of high-debt LDCs suggest that lower U.S. and world interest rates might permit foreign residents to invest a larger share of their domestic saving at home. This would further stimulate foreign growth.

For these reasons, I include two important measures to reduce the U.S. trade deficit as part a package of policies to stimulate global growth. The first measure is to take steps to substantially cut Federal spending and deficits. The Federal budget deficit drains U.S. private saving away from private investment, thus enlarging the gap between what our nation is willing to save and wants to invest. Reductions in Federal spending and deficits should narrow the U.S. saving/investment gap, reduce our reliance on borrowed foreign credit, and set the stage for an improvement in the U.S. trade deficit.

Our saving/investment gap could also be reduced by an increase in U.S. private saving. We are a low saving nation. Gross national saving in the U.S. as a percentage of GNP generally runs 5 to 7 percentage points lower than the average for other industrial countries and has been recently further depressed by large Federal deficits. U.S. personal saving were just 5 percent of disposable income in 1983 and 6 percent last year. This is well below the level in excess of 8 percent in the early 1970s and about half the average rate for other industrial countries. I, therefore, strongly recommend that in the current discussion of ways to reform the U.S. tax code, consideration be specifically given to changes which would encourage greater saving within the U.S. economy. This would raise our long term growth prospects, reinforce the international competitiveness of many U.S. industries and, in the current context, help reduce our need to borrow foreign saving and the trade deficit.

What Can We Do To Encourage World Recovery? Trade Policy

In addition to these major macroeconomic elements of a U.S. package to stimulate growth in the world economy, we also need to address the longterm structural problems which are retarding growth and limiting the attractiveness of many foreign markets to domestic and foreign investors. The principal means at our disposal to encourage greater adjustment, flexibility and efficiency in the world economy are in the area of foreign trade policy. Individual economies will perform better and trade expansion can again stimulate strong growth if we can make substantial progress in reducing the many current barriers and distortions to world trade.

Progress needs to be made on several fronts. The challenge of competitive LDC exports in the basic industries like steel, textiles and consumer electronics has not been well met. Too many industrial countries have responded with subsidies, dumping and import restraints. The trade policy problem is one of reaching agreement among industrial countries on a positive and equitable response to changing world competitive conditions in basic industries.

Trade in manufactures among the industrial countries has also been subject to increasing restriction. Some of these have grown in the last five years in response to pressures generated by capacity idled and unemployment created by the economic slow down. Although we are not directly involved in much of the restriction, such as European limitations on Japanese manufactures, we feel the effects indirectly through the disruption of world markets and the deflection of exports. With respect to Japan we have our own direct problems of market access which stand in critical need of being addressed through an effective understanding with Japan. Many industrial countries remain fearful about a rollback of recent increases in barriers while recoveries are still fragile. I believe these fears to be misplaced, however, because it has been the very growth of such barriers which has contributed to the unusual failure of the strong U.S. recovery to stimulate substantial world growth.

New high technology industries and services have become more important, both in terms of their potential contribution to growth of output and employment and to economic competitiveness. Moreover, with the growing significance of knowledge, intellectual property issues have also assumed greater importance. Countries that lag in the development of the new technologies are often tempted to try to catch up through domestic subsidies and import restraints and many countries have given in to these temptations. The net effect not only reduces U.S. export opportunities, but also the growth potential of our trading partners. We must help them understand that they are better served by a freer international flow of low-cost, high-quality technology goods and services, many of which serve as inputs raising the efficiency and competitiveness of their own domestic production.

A growing trend toward self-sufficiency and over-production in agricultural products by more and more countries, and the dumping of surpluses on world markets has increasingly disrupted the traditional export markets of efficient agricultural producers. No nation's interests are served by the trade restrictive and trade distorting policies used to over-stimulate agricultural production. As we look a few years ahead, advances in biogenetics promise to worsen the effects of government subsidies for agricultural production and exports. Agriculture is an area ripe for international trade negotiation and liberalization.

To address these many trade distortions and restrictions so limiting world growth, I feel we vitally need new multilateral trade negotiations. Such negotiations, if successful, would increase healthy competition in world markets, encourage economic adjustment in domestic economies, stimulate investment and employment, and restore strong growth to the world economy. Not all the domestic adjustment required by liberalization would be easy but the cost of continued refusal to adjust is a waste of resources and relative stagnation for the global economy. Multilateral trade negotiations would undoubtedly take a number of years to negotiate and longer to implement. What is important, however, is that we start the journey, because it will lay out the long-term direction of policy. Moving toward liberalization will also encourage business confidence to make long-term investment decisions aimed at the expansion of the international market and vital to recovery of the global economy.

Key to the package approach I envisage are new multilateral trade negotiations in the GATT and what we hope to accomplish there. There is increasing concern about the adequacy of current trade rules to assure a fair and open trade system. We should seek specific changes which strengthen the fairness of the system with respect to procedures for both the settlement of trade disputes and the imposition of temporary safeguard measures.

Other, equally important objectives should be central to our concerns in a new round. They cover liberalization of trade in the gamut of product areas I have already mentioned, in trade among industrial countries and with developing countries. Nor should any instruments of protection by excluded from negotiation, neither tariffs which still average above 100 percent in some developing countries, nor non-tariff barriers, nor foreign investment regulations when they seek to distort or limit world trade flows.

Conclusion

In conclusion, let me say that the exercise of our leadership in restoring health to the global economy will be difficult with many controversial decisions to be made both with regard to U.S. domestic economic policy and foreign trade policy. We will also need to develop furtner cooperation with our trading partners to accomplish this enormous task. The United States is, of course, enjoying its best economic growth performance since 1951. However, let us remind ourselves that seeking strong growth abroad is in our own interests as well as those of our trading partners in industrial and developing areas. For the success of our foreign policy and the fulfillment of our own economic potential in the years to come will depend in part on our success in promoting strong, sustained global expansion in a system of open world trade.

The CHAIRMAN. Thank you very much, Ambassador Brock. Let me ask the concurrence of my colleagues in suggesting that we limit our questions on this first round to 5 minutes so that each Senator will have an opportunity to ask at least one question and get a response within the time that we have.

Ambassador Brock, let me commence the questions by asking what specific steps ought we take in our relationships with Japan to try to remedy at least a problem that I identified in my opening statement, namely, the unwillingness of Japan to accept manufactured goods in any significant quantity from other countries, and especially from the LDC's, and thus to shift that situation to us and to other countries.

Ambassador BROCK. Mr. Chairman, we have been trying to answer that question for 4 years without sufficient success. The Japanese have taken a number of significant steps. They have announced five rounds of trade packages.

The Prime Minister has repeatedly restated his commitment to open markets, and yet we seem to be reliving the nightmare that I predicted 2½ years ago, when I said I was afraid that at some point the Japanese Government would do all that we have asked them to do and nothing would change.

As a matter of fact, in some ways the situation has gotten a bit worse. You can make the argument that the U.S. primary problem with Japan is the strength of the dollar.

When the VRA was announced by the Japanese in 1981, the dollar was at 212 to the yen. When I was in Tokyo 3 weeks ago, it was 261. Now, that is a 25- or 30-percent change in valuation, depending on the base you use over that 4-year period, and it is an enormous shift in currency valuation.

So, you can argue that at least a significant element of our deficit with Japan is in that shift of the value of the dollar, but you cannot, Mr. Chairman, make that argument, as you have noted, with regard to other countries, because where the dollar has gone up 25 percent against the yen, it has gone up 50 to 100 percent against other currencies, and the yen has gone up against other currencies.

Now, in the normal essence of the trading process, if a country's currency appreciates as the yen has against other currencies, they would be faced with a surge of imports from those countries, not from us but from other countries.

Now, if you look at the charts over here, you will see that the share of industrial country imports of manufactured goods from the developing countries for the United States has gone up to 58 percent for the United States and down to less than 8 percent on the part of Japan.

That means that we are taking over seven times the rate of imports from developing countries that the Japanese are, and it is impossible to make the case that that is a factor of currency valuation, because the reverse should be true. Japan should be taking a larger share and not a smaller share.

And if you look at the chart on the left over here, Japan imports of manufactured goods have changed very minimally, even in raw volume terms, in the face of an improving economic circumstance. That is the difficulty.

What we are trying to do at the moment, following the President's meeting with the Prime Minister, is to follow the so-called market-oriented sector specific approach where we have a very high level team in each of four different areas, maximum political involvement at the level of the U.S. participation but on an equivalency on the Japanese side to see if we can attack those trade barriers that we know exist, where we know we have a competitive industry, we know we have a better price, a better quality, and a better service, and if we can prove that it can be done in those sectors, then use those as examples for the opening up of the markets generally.

But the fundamental problem in Japan goes back almost 100 years. It is not a new problem. Japan has been operating with an island mentality for the last century, in which they believe it is an act of patriotism to import raw goods and export finished goods in order to maximize the value added content.

That psychology affects a significant majority of the business community, most of the bureaucracy, and an awful lot of people. Unless that attitude changes, I am not sure that any government can do very much.

The **Chairman**. Let us say for the sake of argument that a 20-percent surcharge were levied just against Japan, but not an overall sense. Would that change the argument at all? How would that affect the negotiations with Japan?

Ambassador **Brock**. I think the negotiations would become active very quickly. [Laughter.]

The **Chairman**. It would catch some of the tension?

Ambassador **Brock**. It would certainly do that. The question is, you have to determine on what basis you do that. Under U.S. law we have the authority to do almost anything we want to, such as employing 301-type action, if we find that the trade practices of another country have had the effect of impairing benefits previously agreed to with the United States.

That would be a very dramatic and, I think, potentially hazardous decision.

The **Chairman**. Thank you very much, Ambassador Brock.

Senator Kerry, do you have questions?

Senator **Kerry**. Mr. Chairman, may I ask the Chair if it would be permissible for me to hold my round until a later point?

The **Chairman**. Very well. Senator Mathias.

Senator **Mathias**. Ambassador Brock, on the question of exchange rates, we had before the committee some months ago representatives of the automotive industry, vice presidents of Ford, Chrysler, and General Motors.

We have also been in consultation with the steel industry, whose troubles I do not have to describe to you in detail, but which are very close to me at Bethlehem in Sparrows Point. We asked them, on a scale of 10, how would they rate their problems with making exports and combating imports?

The automobile industry said that on a scale of 10, they would rate the exchange rate problem as 5 and the disparities in the tax system in the United States and Japan 5, as well.

Ambassador **Brock**. That is about right.

Senator **Mathias**. You would agree with that?

Ambassador **Brock**. Yes; if you look at the exchange rate that I mentioned, let us take that exchange rate and say that it is 25 percent, and let us take a $6,000 car, which is the cost of the average import at the border, not at the consumer level, but at the border where it comes in to the distributor. A 25-percent exchange rate shift means a $1,500 per car disadvantage that American manufacturers have to overcome.

The Japanese use what they call a commodity tax system that runs from 18.5 to 23 percent, depending on the size of the engine. Let us take an average of 20 percent and say that that $6,000 car that is made in Japan has that commodity tax as they do rebated at the border so that that car has paid no effective taxes in Japan and is competing with American cars that clearly have to pay taxes in the United States to be allowed to produce here, so that car then gets a rebate to the manufacturer of, say, $1,200.

So there is not a whole lot of difference between that $1,200 tax advantage that exists in that setting and the $1,500 currency shift. You could argue that they are virtually the same. When you cumulate the two, you have somewhere between 40 and 50 percent disadvantage for American firms. That is very, very substantial.

Despite the enormous efforts that our firms and workers have made to improve productivity, to improve the capital infusion by better than $40 billion over the last 4 years, the exchange rate alone has wiped out those magnificent efforts, and they have done very well at improving their competitive situation and reducing their base cost.

Senator **Mathias**. The steel industry gave a slightly different formulation, but again, roughly put, about 5 points out of 10 on the exchange rates for their problems. Would you agree with that?

Ambassador **Brock**. I would put steel a little higher in the exchange rate problem, because steel does not have the tax disadvantage. I would think that for the steel factor the exchange rate might be as much as 6 or 7 on a scale of 10, but it is still enormous.

Senator **Mathias**. So we really get back to that hard dollar and to the effect of interest rates, and sequentially to the budget deficit.

Ambassador **Brock**. Absolutely. When I was testifying before the Joint Economic Committee, I was asked to put some sort of percentage ratio on the amount of the problem that has been caused by a relatively strong dollar and relatively weak other currencies as compared to the trade barriers that exist on our products in other countries.

I said that up to 80 percent of our deficit, maybe 75 or 80, could be attributed to the dollar valuation problem as opposed to the actions of other countries.

Senator **Mathias**. Switching to your very interesting comments at the end of your statement on the desirability of a new trade round, yesterday I was visited by representatives of French agriculture, and as you know, France now has a surplus of agricultural products, both in grains and dairy products.

Ambassador **Brock**. And wine.

Senator **Mathias**. China, which has been a grain deficit area historically for many years, has now begun to produce at what is at the present time a very small but still significant surplus of grain in addition to the surplus of rice which they have been producing for some years.

All of this indicates that there is going to be an enormous problem in the field of agriculture, particularly if the United States goes to a free market agriculture in which farmers can plant any amount they want to plant. Would you include agricultural products on your new round? And what other subjects would you put on the new round?

Ambassador **Brock**. Senator, I think the top priority for a new round certainly in the near term is agriculture. It is the largest single problem area in world trade right now. The United States has stated its objectives.

They are basically threefold. First, to clean up the present trade practices dealing with safeguards and dispute settlement issues. Second, to deal with the current trade problems, with agriculture at the very top of that list; to remove agricultural subsidies from world trade and competition.

And third, to deal with the so-called future issues, services, intellectual property rights, investment, those things that have long-term economic interests for the United States.

I cannot envision a trade round that we would participate in at least that did not have as its top priority dealing with agricultural issues, because we cannot let this system continue to go into the massive deterioration that we are experiencing today without dealing with it or we will face a real disaster in world trade.

Senator **Mathias**. My time is up. I cannot but help observe that it is just like a field of weeds. You can see them beginning to grow, and they will be up there engulfing the whole system in a very short time if we do not get them under control.

Ambassador **Brock**. If we do not plow those weeds, Senator, we are not going to get any crop.

Senator **Mathias**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Mathias.

Senator Murkowski.

Senator **Murkowski**. Thank you, Mr. Chairman.

I very much appreciate the opportunity to have the Ambassador here today. I think it is just too bad that we do not have more time, but making the most of what we do have, you, of course, recall some time last year there was a joint energy communique developed between President Reagan and Prime Minister Nakasone that covered a number of energy resources, including coal, gas, and oil.

Through January of this year there were followup discussions about the export of oil from Alaska. I understand from a February 13 edition of the Asahi newspaper in Tokyo that a quote was attributed to you in regard to a statement you made to Prime Minister Nakasone.

The quote, as I have it, Mr. Ambassador, is, "We also wish to make efforts for lifting the ban on exports of Alaska crude oil to Japan."

I wonder if you would elaborate a little further on specifically what efforts the administration is making with regard to that quote, assuming the quote is accurate.

Ambassador **Brock**. Senator, we, basically, do not believe there ought to be any barriers on the exchange of goods and services, period. And that particular barrier is one that is self-imposed.

Our difficulty has never been one of sympathy for the desirability of increasing our exports, but we have faced in the Congress very severe resistance to any idea of opening up that market and letting us sell to any and all.

The administration's position, I think, has been to see if in fact the Congress were willing at this point with an energy glut in the world to reconsider its position. It has been my personal view for many years that any limitation on exports is frankly not in our national interest.

That is a personal view. The administration has not taken a formal position. But it is very difficult for me to justify a continuation of the present practice.

Senator **Murkowski**. As we both know, it is very easy to put the burden on the Congress for the continuation of the restriction, but I am curious to know what you meant when you said, "make efforts for lifting the ban." We also wish to make efforts, and that implies some motivation on behalf of the administration.

I was wondering if you are prepared to elaborate at all on what effort the administration might make other than to just be for no restrictions.

Ambassador **Brock**. It is pretty difficult since the administration has not changed its position for me to state what the administration might formally want to do at some point down the road.

I do not know where that story came from. The Prime Minister and I did discuss the issue, and I stated some personal views, certainly not for the press nor for the public record.

Senator **Murkowski**. That is probably why you were quoted.

Ambassador **Brock**. Probably. I do not know how to answer your question, because the administration has not had this discussion this year. We had it last year, and the decision was to see if the Congress was of a somewhat different mind. The indication was that it was not at that time, but I would imagine we would revisit the issue in the not too distant future, and I hope we will.

Senator **Murkowski**. Well, as you indicated, there has been substantial objection from the maritime interests, and of course the question is, what do we have to do to satisfy this group? Is it a matter of our national interest?

I am told that for every 100,000 barrels of crude oil shipped every year, there would be an offset to the balance of payments deficit with Japan by about $1 billion. Recognizing the significant growth of our trade deficit with Japan and further recognizing that Japan is energy-dependent and must purchase its coal, gas, and oil from abroad, one immediately looks for reasons as to why they are not buying these resources from the United States? Well, as long as we have export restrictions, they cannot buy from the United States.

Ambassador **Brock**. I think that is an eminently fair question. It is not just oil. We have the world's largest coal resources in Alaska, and we have enormous gas resources that could be developed, frankly, with Japanese business investment and win both ways.

Senator **Murkowski**. Might it be appropriate for the administration to consider a policy statement with regard to the role of

Alaska and its resource potential in oil, gas, and coal as it applies to the trade imbalance, particularly with Japan, since the U.S. Government owns about 75 percent of the land in Alaska?

Ambassador **BROCK**. It certainly might.

Senator **MURKOWSKI**. Thank you.

Mr. Chairman, I have one very brief question, if I may have your permission. Much is made of the statement that we cannot do anything about our trade imbalance because of the high value of the dollar, but the dollar is really a result of an open market as opposed to any artificial restraints.

Ambassador **BROCK**. That is exactly right.

Senator **MURKOWSKI**. So if we try to lower it through artificial restraints, are we not in effect in a conflict with our basic principle of free trade in an open market?

Ambassador **BROCK**. Absolutely. I would not for a minute argue that we should try overtly to intervene to reduce the value of the dollar. The problem we have is in part the value of the dollar that is caused by the pressure on our interest rates, caused by the Federal deficit.

The chairman was addressing that, and I was. We have to deal with that problem. But once we remove that governmental impact, the marketplace ought to be allowed to work, and it will work if we will allow it to, to our advantage.

Senator **MURKOWSKI**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you very much, Senator Murkowski.

Senator Evans.

Senator **EVANS**. Thank you, Mr. Chairman.

For as long as I have been in public office, for the better part of 30 years, I have been a strong advocate of free trade. Our State and our particular part of the United States have long enjoyed a very strong surplus in our export versus import trade.

Japan, outside of Canada, is our biggest trading partner. We have had some problems with certain agricultural products. Generally it has been a fruitful and worthwhile relationship.

I hope there are some Japanese observers here today listening, because I am about to end 30 years of an open trade relationship because of the continued absolute stonewalling by the Japanese on opening some of their trading markets.

I would like your comment first on the fundamental view we have in terms of trade restrictions, for example, that they are not only bad policy but that if implemented would lead to retaliation by other governments and thus prove to be self-defeating. That same thesis apparently does not seem to affect the Japanese.

Ambassador **BROCK**. I think that is true.

Senator **EVANS**. What thesis do they work from?

Ambassador **BROCK**. The Japanese have worked on a mercantilist approach, which suggests that it is in their interest as a resource-poor country, that the only way they have to increase their employment and rate of growth is to maximize value, aided by importing raw and exporting finished goods. So they constrain the import of finished products.

Senator **EVANS**. But in doing so they push us into the colonial mode of export of raw materials and import of manufactured goods.

Ambassador **Brock**. Well, I will tell the Japanese that if they continue this practice, I might have to apply for GSP in Japan. [Laughter.]

Senator **Evans**. Let me then turn more directly to the specific and current negotiations going on with respect to timber and paper. It seems to me even with the current disparity in the currency values, that there is an opportunity that we could compete and compete successfully in the Japanese market if trade restrictions were either removed or even leveled with import tariffs for those products in the United States.

Ambassador **Brock**. Absolutely.

Senator **Evans**. I understand that when that subject was broached recently at least the press reports indicated that they ended in a shouting match. Who was doing the shouting?

Ambassador **Brock**. Well, I think we probably began because we so vigorously disagree with the statement. We are constantly told in Japan that they have an open market, and it simply is not factually correct.

We can take your own area, Senator, the whole forest products group ranging from trees down through lumber, plywood, down all the way to end use products like paper. There are very substantial tariff and nontariff barriers to the access of a competitive U.S. product, and there is no one who really argues even in Japan that we have a superior product at a lower price and a complete capacity for service.

Senator **Evans**. How can they legitimately or even halfway legitimately argue that there is an open market or an opportunity that is relatively equal when as I understand it, the specific easily understood and easily observed tariff rates are double for entry into Japan what they are for entry into this country on timber and wood products?

Ambassador **Brock**. In all honesty, they cannot make that argument.

Senator **Evans**. Do you have any estimate as to the potential market in Japan for paper and wood products from the United States if, in fact, those tariff barriers alone were reduced to equality with ours?

Ambassador **Brock**. It is hard to answer, because we believe that if the U.S. products were allowed complete access to the market on a competitive basis, we would so reduce constant demand in the market over there that we would increase the demand for housing, for example.

So, while you can say that we presently could see a market of a billion or two, that probably is understated. We think we could increase the size of the market, the same argument we make with beef.

Beefsteak, if it costs $40 a steak in Japan, means nobody can eat steak, but if we were allowed to sell steaks over there at $5, $6, or $7, as you can here, I will guarantee you a whole lot more people would be eating steak.

It is difficult to put a projection on it, but the fact is, there is no question that we are losing a very substantial market opportunity that would otherwise exist.

Senator **Evans**. What do you see in the near future? What next step should we take, speaking again specifically of the forest products industry, in this continuing problem we have with Japan?

Ambassador **Brock**. Well, we are operating under a fairly specific time table. The President and the Prime Minister agreed upon this sectoral approach. The first deadline is April 1, when their telecommunications decision has to be finalized in the Diet. That will give us a very substantial signal as to whether or not we can expect progress in other areas.

We have been told by the Japanese that there is no possibility of near term progress in much of the forest products area, and I think if that decision holds, we will have to decide what next steps we should take.

We have not made that decision, because we continue to believe that something can change, but at the moment the prospects are not good.

Senator **Evans**. Thank you.

And thank you, Mr. Chairman. I see my time is up.

The **Chairman**. Thank you very much, Senator Evans.

Senator Dodd, do you have questions?

Senator **Dodd**. I do, Mr. Chairman, but Senator Kerry was here before I was.

Senator **Kerry**. Why do you not go ahead, Chris?

Senator **Dodd**. Thank you, Mr. Chairman. Thank you, John.

Mr. Ambassador, we appreciate your being here this morning. We all have a tendency to get a little parochial. I do not want to get parochial, but I had some lengthy discussions the other day with the Commerce Department about an export licensing case.

A Connecticut corporation had applied for an export license on some computers that it wants to sell to the PRC. It was pretty technical and sophisticated equipment, so there was reason to make sure that we were not transferring some technology that could violate some national security interest.

But we discovered in that particular case that the paper work was just lost. It is a significant business arrangement if it were to be approved. They literally lost correspondence, applications, the computer kept popping up saying no action yet, so the company assumed that they just had not gotten to them yet.

Whether or not they lost it has not yet been determined. The Chinese are very upset, and I had hoped that this month they would be able to terminate the discussion on the export license. It is now going to be another 9 months, having just discovered the problem yesterday. We are hopeful that they will understand what happened in this particular case.

Is that an isolated case? Or is this something that is more a pattern of behavior that we are finding?

Ambassador **Brock**. I hope it is isolated. I do not believe it is a pattern of behavior. It certainly is not the intention of the Commerce Department. I cannot speak for them or for their practices other than to say that I have had a number of conversations with the Secretary on the subject, and I know of the enormous effort that he has made to improve the internal procedures in order to avoid just precisely that kind of situation.

Senator DODD. Maybe I should not ask the question about a pattern of behavior because I happen to believe the Secretary is working very hard as well on the issue, but is this a common complaint? What steps are being made to expedite this where possible?

This particular case is a COCOM case, by the way, and that would take some additional time, so I am not suggesting that this ought to be avoided, but what sort of steps are being taken to see to it that this whole licensing process is expedited to the extent possible?

Ambassador BROCK. You will get a more precise answer from the Commerce Department. Since I am not privy to all that they do at this level, I am a little constrained. But they have significantly beefed up their manpower. They have tried very hard to reduce the amount of time that it takes for an application to be processed.

Part of the problem has been compounded by difficulty in reaching an agreement with the Congress on a new Export Administration Act, and the internecine battles that have gone on within the bureaucracy which are not good for anybody in my judgment.

But even laying that aside, I think the Commerce Department has made a very sizable effort to strengthen its procedures, to clarify them, to simplify them, and to make them more efficient for the benefit of exporting firms.

Senator DODD. The President in a State of the Union Message 2 years ago, made a rather strong statement in support of the Eximbank in terms of the role it played in promoting exports from the United States.

As you know in this year's budget the administration has taken a rather different view of the Eximbank in light of other legislative capacities. I serve on the Banking Committee, and we have had hearings with the Eximbank, and understandably deficit issues are dominant in all of our minds.

But there is real concern that this kind of signal at this particular time, given the problems that still exist with our major competitors in terms of heavy governmental involvement in the promotion of their exports, export industries, that this is exactly the wrong kind of signal to be sending at this time concerning our efforts to reduce that kind of Government support.

What are your views on that? Do you agree with Mr. Stockman and others, who apparently have been the source of that proposal regarding the Export-Import Bank?

Ambassador BROCK. Well, as we were saying earlier, the largest single problem we have in the trade area is the Federal deficit and its impact upon both long-term interest rates and on the value of the dollar. So, in a very general sense, I certainly do agree with almost any action that would have an effect of reducing that deficit, but let me take that to a more specific response, Senator.

There are a couple of problems associated with this particular activity. One is the very methodology by which we do our accounting in the Federal Government when we consider a loan or a loan guarantee, not in this case, but some, as an expenditure, and they are not the same thing. Any business that operated the way we do would be hard pressed to stay in business.

It seems to me that you can make the case that the amount of money that is put into Exim for support of exports comes back 7, 8, 9, or 10 times, so it is a yielding investment. It is not an outlay in the classic sense of a payment for ammunition for the Defense Department.

So I really think part of it is the compounding complication of the methodology, the accounting, and in that sense just the removal of a few billion dollars from the budget does help on the surface to deal with the deficit, even though it may not quite have the impact in truth.

I think it is important to point out that the interest buy-down can maintain our ability to meet outrageous forms of government intervention in a limited fashion, and perhaps if interest rates stayed down, almost to the same degree as the direct loan program did, so it may not be a reduction in the Eximbank support of business.

It is fair to give them a lot of credit for helping to negotiate a reduction in these practices on the part of other governments. We really have made a lot of progress in that regard.

The primary problem remaining is in the area of mixed credits. We just lost a sale, a very significant sale, recently where another government provided just enough mixed credits to get above the formula level, and that in effect brought down their interest rates below the agreement level. Now, that is what we have to deal with.

It is tough to deal in a negotiation unless you have some tools with which you can compete, so I am sympathetic to your argument, but under the circumstances I do not think we have much choice but to try this alternative round.

Senator DODD. My time has expired. It was a short round. But I do appreciate your response. I will get back to this.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Kerry.

Senator KERRY. Thank you, Mr. Chairman.

Mr. Ambassador, I think I would pick up a little where my colleague, Senator Evans, was, which was partly expressing a deep-felt sense of frustration, which I think everybody is beginning to feel. In looking at your testimony and in listening to you, I sense—well, I more than sense, I read and hear of reliance on multilateral negotiations and continued talk as being perhaps enough to resolve this problem.

Yet as I look at the history, what was 10 years ago limited to perhaps textiles and televisions and automobiles is now, after years of talks, extended to telecommunications equipment, computers, a host of other industries.

Most recently I read in the Times of vitamin E, and there are still beef and citrus quotas. There is a plywood tariff. I think if we look at the total balance of trade problems that we have, a $37 billion trade imbalance, $20 billion of which are automobiles, we can hardly hope to make it up in that market.

Also, if you look at what Japan is doing with its trade surplus, its trade surplus is not in any way appreciably appreciating the yen. It is largely being invested in dollar securities.

Also, I believe what you referred to and others referred to as the elasticity of the Japanese economy is such that there is not a great deal of room for import growth.

So, if you look at the whole picture, and if you look at it over a 10-year period of time, and if you look at the increasing technology competition that exists in the world, and I represent, needless to say, a State which depends on that technology exchange, I am not encouraged by the notion that these talks are going to produce anything.

I almost see a strategy on the part of the Japanese that welcomes more talks, because every time we talk, they can increase market share, and in fact we have seen that.

So I wonder what there really is that says to you as an experienced person, a veteran of this process, one who understands it, what says to you that talks are really going to produce anything?

Is it not time for us in defense of industries in this country and in defense of our future and capacity to compete and to preclude over these next few years the increasing loss of market share and the longer term of catch-up, is it not time for us to take a stronger series of steps to make clear our determination to be able to compete on a level playing field?

What is there, if you do not think it is time, that says to you that these talks really hold out a prospect of producing something?

Ambassador **Brock**. It may be time. I think in the specific instances of the Japanese talks, we certainly do not have to consider any change in the present pattern until after we have seen the results, because we have a deadline of April 1.

That is a near term deadline. And we will know whether or not they are serious. I have to take the present system that the President has given us and pursue it to that conclusion.

In the instance of the larger question that we have been asked about, trade actions around the world where we do face a whole range of practices that disadvantage this country, I think it may be time in a number of instances to do more than talk.

As a matter of fact, the Congress gave us the authority to strengthen our actions when you passed the trade bill in October of last year. That to me was a pretty clear message that the Congress expected us to be more aggressive and to take specific actions when the alternative was impossible, and I take that instruction seriously.

So we have begun to explore what additional steps could be taken. But one of the fundamental problems, Senator, in the whole area of trade policy, one of the fundamental dilemmas is that it is very difficult to find an action that does not do us more damage than it does the other party.

And it is hard to expect them to take us seriously when they know we do not want to impose more pain on ourselves than we do on them. You do not go after somebody by shooting yourself in the foot.

The suggestions of an across-the-board import surcharge would be in that category. It sounds good. It has a surface appeal, and it helps to deal with, (a) the trade deficit, and (b) the Federal deficit.

But if it does in fact cause strengthening of the dollar, which is our fundamental difficulty, and makes that matter worse, it has offset its own solution and left us then with no effective remedy except less trade and more inflation and less growth.

So, you have to be very careful. I constantly get from some of my colleagues in France this attack on the American exchange rates, monetary policy, and fiscal policy, and I say, well, fine, go ahead and attack it, but tell us what you would do to fix exchange rates in a free market. I mean, it is a contradiction in terms.

I am not unsympathetic to what you are saying. I am not even sure that I disagree with what you are saying.

Senator KERRY. I know that my time is up, Mr. Chairman. But may I ask one more question?

When you say shoot ourselves in the foot with respect to the Japanese or with respect to other trading partners, what do you mean?

Ambassador BROCK. Well, in any event, you have to evaluate the action on a particular country or overall in terms of what it does to us. That is the reason we lifted the VRA's, because we thought they were doing us more damage than the Japanese by yards. We were paying them monopoly rent to continue that process.

Senator KERRY. But there is not one product that we are importing from them that we cannot buy somewhere else.

Ambassador BROCK. That is true. And you will see an increase in Korean imports in automobiles soon.

Senator KERRY Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Kerry.

I hate to announce that the Senate is probably leaving for the House at this moment, at 10:40, so we will need to join our colleagues en route.

Ambassador Brock, we deeply appreciate your coming before us, and we regret the truncated schedule that the leadership has imposed upon us, but we appreciate your testimony and your forthcoming answers as always.

Ambassador BROCK. Thank you for having me, Mr. Chairman. It was nice to see you.

[Whereupon, a recess was taken.]

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is underway again.

We are very grateful to have our distinguished witnesses. Gentlemen, we appreciate not only your talents but your patience in waiting through the Senate procedures this morning. We have had a very successful joint session with the Prime Minister of Italy, who was well received, and now Senators are returning to the business at hand.

The panel that we now have before us consists of Mr. Dwayne Andreas, Mr. Robert Roosa, and Mr. Alexander Trowbridge. Gentlemen, we would ask each of you to provide your own personal perspective on how economic growth in the global sense can best be stimulated and sustained.

I will ask that you testify in the order, first Mr. Andreas, and then Mr. Roosa, and then Mr. Trowbridge. All of your statements will, of course, be placed in the record in full. You may proceed as you wish in terms of abbreviation or comments that will characterize your testimony.

Mr. Andreas, will you proceed?

STATEMENT OF DWAYNE O. ANDREAS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, ARCHER DANIELS MIDLAND, DECATUR, IL

Mr. ANDREAS. Thank you, Mr. Chairman. I will try to shrink mine down to about 5 or 7 minutes, with your permission, and the rest of it will be in the record. I will try to hit the highlights.

I do appreciate the opportunity to be here. I do consider it a privilege and an honor. The views I express here will be my own, but they have been influenced greatly by what I learned as chairman of the President's Task Force on International Private Enterprise.

Our task force studied the problem of international trade and aid for a period of about 18 months, and issued a rather extensive report which has been made available to every member of this committee.

Basically what our task force found is that there is an economic war going on out there, and we, meaning the United States, were acting as though we are nonparticipants.

I feel and our task force felt that not enough attention has been paid to the overriding global fact of this decade, which in terms of trade is that the friendly democracies have mostly evolved into centralized, socialistic, mercantile states.

They are competing globally with private enterprise not on the basis of comparative advantage, but rather through dependence on import restraints and export subsidies. We have learned to live with and expect to live with such state trading from the Socialist bloc countries.

But we have been slow in fully recognizing the damaging extent to which the socialistic democracies, the Western countries are using mercantile practices, and that is becoming the rule rather than the exception.

In such other industrialized countries as France, Germany, Italy, Japan, Canada, and even Brazil and Korea, hardheaded government policies are implemented to minimize imports and maximize exports. Even Hong Kong, which is supposed to be a bastion of free trade in the Far East, has just invoked a 300-percent tariff on American cigarettes to shut out the imports into one of our traditional markets.

These mercantile states, Western democracies, have a favorable balance of trade due largely to the permissiveness of the United States. We have earned the title of paper tiger in foreign trade circles because we have not fought back. We have not attempted to fight fire with fire.

The result is that the Third World and the United States have become dumping grounds for products seriously jeopardizing our economy, and we are rapidly losing our traditional share of third country markets to those state-supported and subsidized competitors.

My purpose in bringing this subject to your attention, Mr. Chairman, is, we feel that during the rest of this decade foreign policy will be dominated by these economic considerations. We are in a state of siege. Four potential crises threaten to uproot many of our basic foreign policy premises.

First, the deterioration of the U.S. balance of trade with no end or even plan to end in sight. Second, the danger of depression led by skyrocketing deficits. Third, the already huge and still growing tendency of the mercantile states to compete with and weaken the private enterprise system. Fourth, the danger of massive defaults in one or more of the developing countries on their debts.

We believe these problems cannot be handled any more on an ad hoc basis. We have nearly 15 Government agencies dealing with foreign countries, bargaining with them, doing things for them. None of them has the muscle to boil things down to a quid pro quo and make the kind of arrangements that we have to make in order to continue with fair trade globally.

Our task force concluded that the U.S. Government needs a new management structure to deal with these critical areas. We need to be better equipped to deal with day-by-day trade and economic decisions which deeply affect us in global economic affairs and to provide adequate action to prevent mercantile states from driving free institutions, farmers, and workers out of business.

We must be more aware of what other industrialized countries have learned, namely, that a coordinated and comprehensive domestic and international economic policy lies at the very core of national survival. We must organize ourselves to deal with the global economy and trade policy in a forceful and decisive way.

Certainly these considerations will increasingly dominate the foreign policy agenda, and your committee will be heavily involved. The task force recommended elevation of economic policy to a level comparable to national security. We proposed the establishment of an Economic Security Council in the White House to deal with the complex economic issues just as we do with military and political issues.

This council would serve the President by recommending long-term strategies on such matters as trade, debt, tax policy, and foreign policy assistance, which would serve as guidelines for all the agencies of the executive branch. The President should chair such a council so that its decisions would have the full force of the Presidency throughout our Government.

We came to two other conclusions that we feel such a council would come to. First, nearly $7 billion of mixed credits are being thrown at our business institutions by our friendly neighbors. We are not fighting back.

The Export-Import Bank has 14 billion dollars' worth of "dry powder." We believe that money should be visible, laid on the table and made available for a substantial surge of mixed credits financing, U.S. industrial exports.

Our task force also recommended the doubling of Public Law 480 above the 1984 fiscal year level, not only to meet humanitarian needs.

Government studies show that it has been a great market development program, and they show that this can be done at no cost to the Treasury, since there would be substantial savings in the deficiency payments, loan acquisitions, and storage costs in our farm program.

We are now faced with the crisis in the Middle West. The prices of land are falling like a stone. As far as we can see, the only way to really arrest that is to market what the farmers so ably produce, and we believe that exports can be boosted up to the farm exports from their present low level of $35 billion up to perhaps close to $50 billion in 5 years, with aggressive market development programs.

I believe if we are to fulfill our destiny, which I believe to be to utilize the unique spot we occupy on the globe, we must take the leadership to end starvation in the world. We must never again find ourselves in such a position that we have to retire from international competition and resort to a payment-in-kind program to pay our farmers to abort the production of food.

I am glad to be able to mention to you today that there are two organizations that have come into existence in recent years. One is the Export Processing Industry Coalition [EPIC], which is a coalition of processing companies and labor unions with farmers as auxiliary members, to call attention to the Government for the need for us to continue exporting value added products.

Another coalition between labor and industry is the Labor Industry Coalition for International Trade [LICIT]. LICIT has made some very important recommendations for new legislation that is necessary if our trade position in the world is to continue to be strong.

Now, there is a major difference between the market and a free market. In our studies we found that among the top 20 commodities traded in world trade, not a single one of them is traded in a free market. There is a market, but it is not a free market. Free market is something that I have advocated all my life and lobbied for, but right now it is a philosophical consideration, and it has nothing to do with the real world.

Let me give you an example of one of the most outrageous market policies that this country is up against. I am quoting here Mr. Daniel Amstutz, the Under Secretary of Agriculture for International Affairs at USDA.

He said, in regard to the EEC's policy of paying 27 cents for sugar and dumping it mercilessly on the world market at 4 cents a pound with 1 billion dollars' worth of export subsidies: "It is probably realistic to say that for the past 3 years the price impact has been between 10 and 12 cents a pound. This means that EEC sugar policies"—dumping sugar and export subsidies—"have cost the sugar exporting developing countries $2 billion a year in lost export earnings."

Without that dumping policy in the EEC, the United States would not even need a sugar program, but we have one, and of course if we did not have one you would expose all of our corngrowers and our canegrowers and our beetgrowers to the full destructive effects of the EEC dumping operation.

Government and private entity collaboration appears to be already an accepted part of the global free enterprise system. We should accept this reality and learn to compete. Perhaps it is time that our political forces follow the example of America's organized labor, American industry, and American farmers in putting aside past differences to work together hand in hand toward keeping our economy going and competitive.

Together we must develop programs and policies that assure us fair access to world markets, whatever it takes. Too much is at stake to do any less.

Thank you, Mr. Chairman, for this opportunity.

[Mr. Andreas' prepared statement follows:]

Statement of Dwayne O. Andreas, Chairman of the
Board and Chief Executive Officer, Archer
Daniels Midland Company, Decatur, Ill.

Mr. Chairman, Members of the Senate Foreign Relations Committee:

I appreciate the opportunity to discuss with you a very important issue -- America's role in revitalizing the international economy, and on impediments to private enterprise growth: both in our own country, and overseas.

The views I express here will be my own. They have been, however, greatly influenced by what I learned as Chairman of the President's Task Force on International Private Enterprise. The focus of that Task Force was on the private sector, and, in particular, trade and investment in developing countries. I have supplied to this committee copies of our recently issued report to the President.

As a nation, we rely heavily on the private sector for the strength and vitality of our economy. Anything that undermines that private sector also threatens our economy, and interferes with achievements of national objectives.

For that reason, what is happening to the private sector in the currently distorted world marketplace should be of deep concern to this Committee.

There is an economic war going on, and we are acting as if we are non-participants.

Not enough attention has been paid to an overriding global economic fact of this decade: that friendly democracies have mostly evolved into centralized, socialistic mercantile states.

They are competing globally with private enterprises, not on any basis of comparative advantage but rather through dependence on import restrains and export subsidies. We have learned to expect, and live with, such state trading from what is normally considered the socialist bloc countries. But we have been slow in fully recognizing the damaging extent to which such socialistic mercantile practices are becoming the rule, rather than the exception, among our supposedly democratic allies.

In such other industrialized countries as France, Germany, Italy, Japan, Canada, and even in Brazil and Korea, hard-headed government policies are implemented to minimize imports and maximize exports. Even Hong Kong, the supposed bastion of free enterprise in the Far East, is invoking a 300% tariff on American cigarettes to shut out imports from the U.S. and capture one of our traditional markets.

These mercantile-practicing states have favorable balances of trade, thanks to the permissiveness of the United States. We merely exchange polite notes of concern with what are semantically called our "trading partners". We bargain from weakness -- and get smiles, but little else, in return. No wonder we are earning the title of "paper tigers" in foreign trade circles.

The result is that the Third World and the United States have become the dumping ground for products seriously jeopardizing our economy, and we are rapidly losing our traditional share of third country markets to these state-supported and subsidized competitors.

If the current trend continues, we will simply export raw materials like wheat, corn, iron ore, and coal; and import finished products like automobiles, machine tools, and thousands of other manufactured items. We are now exporting lumber, and bringing back furniture built on a morass of subsidies against which private domestic industry could never compete.

If this goes on long enough, we will be reduced to the status of the colony we once were, and fought a war to end. And it will be a long road back.

During the rest of this decade, foreign policy will be dominated by these economic considerations. Four potential crises threaten to uproot many of our basic foreign policy premises, and cause acute problems:

First, the rapidly, deteriorating U.S. balance of trade -- with no end, or even plan, in sight.

Second, the danger of depression -- led by the sky-rocketing U.S. Federal fiscal deficit.

Third, the already huge -- and still growing -- tendency of mercantile states to compete with and weaken the private enterprise system.

Fourth, the possibility of massive defaults in one or more of the developing country debtors.

These problems cannot and must not be handled on an ad hoc basis.

Our Task Force concluded that the U.S. Government needs a new management structure to deal with these critical areas. We need to be better equipped to deal with day-to-day trade and economic decisions that deeply effect us in global economic affairs, and to provide adequate action to prevent mercantile states from driving free institutions out of business.

Our policies are fragmented, our signals confused with respect to trade, trade financing, agricultural policy, and food assistance, to name but a few. It goes well beyond our relations with the Third World, encompassing our relations with our Western partners and Eastern Bloc countries as well.

We must be more aware of what other industrialized countries have learned: namely, that a coordinated and comprehensive domestic and international economic policy lies at the very core of national survival.

We must organize ourselves to deal with the global economy and trade policy in a forceful and decisive way. Certainly, these considerations will increasingly dominate the foreign policy agenda -- and your Committee will be heavily involved.

The Task Force recommended elevation of economic policy to a level comparable to National Security.

We proposed establishment of an Economic Security Council in the White House to deal with the complex of economic issues just as we do with military and political issues. This council would serve the President by recommending long-term strategies on such matters as trade, LDC debt, tax policy, and foreign policy assistance, which would serve as guidelines for all agencies in the Executive branch. The President should chair it to give its decisions the full force of the Presidency.

Perhaps the Congress can provide leadership in creating such a permanent body. If it is willing to tackle the challenge, it will find support from almost every major segment of the American economy -- organized labor, enlightened business and industry, and most of all the united support of American agriculture.

We must press these mercantile nations into what amounts to economic disarmament talks. To do so, we must begin from a position of strength. We must arm ourselves, so that we will be seen as willing to bring the full force of U.S. economic power into play -- and not hesitate to use it. We must be prepared to match action for action -- whatever it takes to make us fully competitive.

The Export-Import Bank has $14 billion worth of "dry powder". This power should be visible -- laid on the table and made available for a substantial surge of mixed-credits for business exports.

Our Task Force recommended the doubling of P.L. 480 above the 1984 fiscal year level, to meet humanitarian needs. Government studies show that this can be done at no cost to the Treasury since there would be substantial savings in deficiency payments, loan acquisitions, storage costs, etc.

I believe if we are to fulfill our destiny, which I believe to be to utilize the unique spot we occupy on the globe, we must take the leadership to end starvation in the world.

We must so organize as to never find the need to adopt a payment-in-kind program to abort the production of food in a starving world.

Under the Food for Peace legislation, exports must move under the Cargo Preference provisions, i.e. 50 percent in U.S. bottoms at at least double the cost -- and charged against the USDA budget for P.L. 480.

Also, it has just been determined by a U.S. District court that blended credit exports must be shipped under similar provisions. The time has arrived that if it is U.S. policy to provide for special subsidies to the U.S. Maritime industry, then it should be done by direct appropriations. It must not be done by reducing the amount of money available to feed the hungry -- and even starving -- or to adversely affect U.S. farmers by making it even more difficult to compete. Cargo preference is like an export tax on the American farming community. The American farmer does not need any additional negative factors affecting his income.

It has always bothered me that we accept the need to bargain from strength and power to seek peace and disarmament, but seem to think we can bargain from weakness on the economic front.

Mixed credits to stimulate industry and expanded P.L. 480 to stimulate agriculture would be justified, not as any subsidy to American farmers, American workers, or American industry, but to advance the national interest and maintain our premier position in the global economy.

I fully recognize some cost implications. Our studies indicate that any such costs involved in making us competitive will be returned quickly by the economic benefits to our country, and improved revenues to our government resulting from increased exports.

And any such investment is miniscule, when measured against the fact much of this government-in-business competition from our trade rivals is financed, directly or indirectly, by American taxpayers. How? By picking up the tab for $100 billion in defense costs for the EEC and Japan, we enable them to finance economic trade warfare. The World Bank, to which we contribute 25 percent of the total capital, provides subsidized loans to countries which, in turn, subsidize exports to compete against our producers, processors, and workers.

Let me emphasize that my observations are based on genuine concern from all of us -- workers, farmers, businessmen -- that our national security is seriously involved in these issues. Also, deeply involved is the international economic stablity so necessary as a foundation for a world at peace instead of a world in constant crises turmoil.

The U.S. 1984 trade deficit of over $123 billion severely damaging for our economy.

When these trade deficits, coupled with the U.S. budget deficit, erode the confidence of foreign investors in the U.S. economy, the turn-around could be very quick indeed, and devastating to the international economic system. If the U.S. economy is to continue to serve as the engine of global recovery, its strength must rest on a sustainable balance, and on sound monetary, fiscal, trade, and agricultural policies.

Private enterprise has a social consciousness, and shares national objectives. We want to help make the system work, for everyone -- not just ourselves.

What determines private sector behaviour, however, is the marketplace itself, the most important part of which is inevitably shaped by government policy.

The private sector can fulfill its full potential for benefit of the entire economy if the government successfully creates an environment that supports the growth of private sector activity -- and defends it from foreign government intervention policies which can destroy it. We can't do it alone. Our government is the only domestic institution which is capable of effectively dealing with an accelerating tendency of our sister democracies to unfairly compete globally with our private enterprise, by employing import restraints and export subsidies. And by our private enterprise, I mean not only American business but American workers and American farmers struggling for survival.

During our Task Force study, we encountered example after example of how American workers, American farmers, and American industry are victims of our so-called trading partners in this undeclared economic warfare.

Let me just cite the estimated loss to the United States economy of more than 450,000 jobs, $2.1 billion in treasury revenues, and $31 billion in gross economic product, as a result of subsidized competition for the export of processed agricultural products alone-- an area with which I am most familiar, because it involves my own business and my own experience.

The estimate is not just mine, nor officially that of our Task Force. It is one that we respect and with which we agree, however.

for it has been carefully documented in a resource paper recently issued by a unique coalition facing up, in an organized way, to this challenge I am calling to your attention.

That Coalition is called EPIC -- the Export Processing Industry Coalition, with which some of you are familiar. Both the Senate and the House have adopted resolutions upholding objectives of this coalition -- the expansion of the processed product share of agricultural exports, because of the greater economic multiplier effect benefitting the entire U.S. economy. The Coalition is made up of the Industrial Union Department of the AFL-CIO, along with the nation's flour millers', all of our corn refiners, and the soybean processing industry, plus ten international labor unions rightly concerned about the loss of jobs accompanying loss of agricultural export markets.

The Coalition is unique in its own right -- with management and organized labor joining hands in a common cause intended to benefit not only themselves but America's farmers and the entire national economy. It is seldom you in Congress are faced with such a solid front of sometimes conflicting interests. EPIC's resource paper, documenting America's economic price for value-added exports lost to subsidized overseas competition, is entitled "How Much are we Losing? The Impact on Output, Jobs, and Revenues from Lost Exports of Value-Added Products". I commend it to members of this Committee, Mr. Chairman, and ask that it be appended to my testimony in your hearing record.

Similar cooperation between labor and industry has been effectively demonstrated by LICIT -- the Labor-Industry Coalition for International Trade. LICIT is sponsoring the Trade Law Modernization Act that could and should be one of the significant contributions this Congress could make to improving our economy. Our trade laws are out of date and inadequate. They were enacted in another era and cannot cope with the realistic trading world of today. Over the last year, major American corporations and industrial unions working together in LICIT have hammered out a constructive modernization program for these laws that deserve your careful consideration.

Mr. Chairman, I ask that the list of membership of LICIT be included at this point in my testimony.

Mr. Chairman, I find it significant that organized labor is cooperating in such initiatives to strengthen our free enterprise system. I'm proud that responsible leaders in American business and industry are working shoulder to shoulder with spokesmen for America's workers in seeking better trade law remedies.

We must recognize that government and private entity collaboration are deeply ingrained in the national food and industrial policies of most nations; and these nations are reluctant to change these policies. To date, we have been unable to change such policies when they conflict with "free and open trade".

Free and open trade is a worthy long term objective which should be pursued. But we should not pursue it so blindly that we fail to recognize that for all practical purposes, governments and government - supported trading have destroyed any semblence of really free markets.

There is a major difference between the market and the free market. For example, on December 3rd in a speech to the 1985 Agricultural Outlook Conference, Daniel G. Amstutz, Under Secretary for International Affairs at USDA, stated:

"EC policies that encourage sugar production and export of the surplus by using subsidies contribute to sugar oversupplies and depressed world prices, which are particularly damaging to developing countries that depend on sugar exports to earn much of their foreign exchange.

"It is probably realistic to say that for the past three years, the price impact has been midway between the two -- 10 to 12 cents. This means that EC sugar policies have cost the sugar-exporting developing countries about $2 billion a year in lost export earnings."

A study just completed by the highly respected Economic Prospects Inc. of McLean, Virginia, reveals that in the absence of EEC subsidized exports we would not need a special sugar program. Market prices would be above current U.S. levels. Not only are U.S. and world sugar producers being hurt, but also U.S. corn producers are being adversely affected by EEC sugar subsidies. I am attaching a copy of the summary of this report.

I have been involved in commodity trading for all my adult life. Despite all the lip service to free markets, there is no real free market in any of the twenty top commodities traded in world commerce. Free trade provides grist for the philosphers, but we have to deal in the world as it actually is.

Government-private entity collaboration appears to be already an accepted part of the global free enterprise system. We should accept this reality, and learn to compete.

Perhaps its time that our political forces followed the example of America's organized labor, American industry, and American farmers in putting aside past differences to work together, hand in hand, toward keeping our economy competitive.

Together, we must develop programs and policies that assure us fair access to world markets -- whatever it takes.

Too much is at stake to do any less.

Thank you, Mr. Chairman, for this opportunity to express my views. I would be glad to answer any questions you or members of the Committee may have.

EPIC Export Processing Industry Coalition

Sponsoring Members
Industrial Union Department, AFL-CIO
Corn Refiners Association, Inc.
Millers' National Federation
National Soybean Processors Association

Participating International Unions
Allied Industrial Workers of America
American Federation of Grain Millers
Bakery, Confectionery & Tobacco Workers
International Molders & Allied Workers
International Union of Operating Engineers
International Woodworkers of America
Oil, Chemical & Atomic Workers
United Brotherhood of Carpenters & Joiners
United Cement, Lime, Gypsum & Allied Workers
United Steelworkers of America

Labor Coordinator
Nolan W. Hancock,
Director
Citizenship-Legislative Department
Oil, Chemical & Atomic Workers International Union, AFL-CIO
1126 16th St., N.W., Suite 411
Washington, D.C. 20036
(202) 223-5770

Industry Coordinator
Herbert J. Waters,
President
TADCO Enterprises
P.O. Box 259
Falls Church, Virginia 22046
(703) 533-2910

President
Daniel E. Shaughnessy
1008 North Randolph Street
Suite 206
Arlington, Virginia 22201
(703) 243-2377
TWX: 710-955-9826
EXPORTS AGTN

HOW MUCH ARE WE LOSING?

THE IMPACT ON OUTPUT, JOBS AND REVENUE FROM LOST EXPORTS OF VALUE-ADDED PRODUCTS

A Resource and Discussion Paper

Provided by

The Export Processing Industry Coalition

September 1984

Working Together to Expand U.S. Exports of Processed Agricultural Products

THE IMPACT UPON THE U.S. ECONOMY FROM THE LOSS OF EXPORTS IN SELECTED VALUE-ADDED AGRI-PRODUCTS

> "Agriculture is so tightly woven into the fabric of the U.S. economy that its importance is often taken for granted. The fact is, the food and agricultural complex is our nation's biggest business. It accounts for about one-fifth of our Gross National Product - $433 billion - and has assets in excess of $1 trillion. It is also the nation's largest employer, providing 24 million jobs on and off the farm."
>
> Daniel G. Amstutz
> Under Secretary for
> International Affairs &
> Commodity Programs, U.S.
> Department of Agriculture
> (March 13, 1984)

Robert E. Jones
Archer Daniels Midland Co.
August, 1984

INTRODUCTION

The 1985 Farm Bill will receive more attention from agribusiness and allied industries than at any other time in history- groups which have not overtly been involved in past legislation.

The reason is clear. The food and agricultural processing sector is the nation's largest industry and greatest asset. It accounts for about one-fifth of our Gross National Product- $433 billion- and has assets in excess of $1 trillion-nearly 50% of the combined assets of manufacturing, retail and wholesale industries. It is the nation's largest employer providing 24 million jobs both on and off the farm-nearly 25% of the total labor force.

Because of the magnitude of this sector, it is irrevocably woven into the fabric of the U.S. economy and therefore affected by macroeconomic forces within the economy.

This also applies to farming. Today's farms are larger, more capitalized, and provide raw materials to a plethora of industries which process, distribute, and market them. The result is inter-dependence. Farm concerns are the concern of the agri-processing and distribution sector, the supporting industries, and indirectly all economic sectors.

Those factors which affect the health of the farm sector in general and its productivity base in particular directly and indirectly affect the health of a variety of businesses due to the linkages of the farm sector with other economic sectors.

The food and agricultural sector is highly specialized. There are numerous stages of production involved in delivering a product to the ultimate consumer. Numerous industries sell their output to other industries rather than to final markets. Inter-industry transactions account for 50% of the total U.S. economic activity. Associated with that activity are gross economic output, corporate output, jobs, personal income, and tax revenues.

The farm economy and those industries allied to it have not shared in the recessionary recovery process. Therefore, those industries have a vital stake in the development process of the 1985 farm bill.

THE ROLE OF FARM EXPORTS

Both the farming and processing sectors are dependent upon exports for their health and viability. When raw commodities are processed and then exported, the economic benefits which accrue to the economy are maximized. Raw commodity exports involve exporting in bulk with relatively little labor input and involvement of only a few sectors of the economy outside of agriculture. When those commodities are processed further and then exported, the economic benefits associated with the processing are much greater and more broadly distributed throughout the economy.

One-third of the cropland in this country produces for export. Agricultural exports represent one-fourth of all U.S. exports. International trade is the "flagship" of the world economy. It is a huge market. Its volume is equal to, or greater than, that of the oil industry. Insuring our "right of access" to this market is critical to the entire food and agricultural sector. Access is also critical to the entire economy as a major weapon in dealing with the disastrous foreign trade balance.

The 1985 Farm Bill must place a high priority upon programs and policies which insure access to world markets especially in the area of semi-processed and processed products which maximize the benefits to the overall economy.

U.S.COMPARATIVE ADVANTAGE

Perhaps no other sector of the economy enjoys a comparative advantage to compete in world trade than the agricultural and food sector. Economic logic and the laws of comparative advantage dictate that we should be able to compete with any nation for a "fair share" of export markets. We possess the most sophisticated, least cost production,processing,and distribution infrastructure in the world. Yet our market share has been severely eroded over the years especially in the area of value-added processed commodities.

U.S. Agricultural Export Performance

Item/Indicator	1969-71 (average)	1979-81 (average)
U.S. Share-World Exports		
By volume	20%	39%
By value	15%	18%
Export Unit Values		
World Average	$190	$530
U.S. Average	$125	$260

Source: USDA-ERS

The concentration of U.S. exports at the low-value end of the scale reflects the fact that 1. we have reverted to the status of raw material supplier in world trade and 2. that we have failed to derive the greater economic benefits from the existing value-added market. The result is lost jobs, personal income, corporate output, and federal tax revenues.

FACTORS BEHIND THE MARKET SHARE EROSION

A multiplicity of factors have contributed to the erosion of the U.S. market share- the worldwide recession, the chaos in the international financial system, federal monetary policies, farm policies which price supports above market clearing levels, offshore production, ineffective trade embargoes, predatory trade practices of foreign competitors, a deceleration in the rate of demand growth, credit and foreign exchange problems in developing countries, and increased competition from offshore producers with sophisticated agri-complexes in place.

But the single most important cause of market share erosion lies in our failure to comprehend and respond to the changes that have taken place in the global marketplace. Because of this, we have failed to develop programs and policies which are responsive to and insure our access to that marketplace.

We continue to view international trade as a place where " free market" rules apply; where price and the free flow of goods are determined by supply/demand equations; where the laws of comparative advantage prevail; where nations exploit their comparative advantage on goods they produce and process efficiently, and import those goods that are more effectively produced elsewhere.

THE REAL MARKETPLACE

In reality, we are competing in a market within which successful trade often involves governmental and private entity collaboration; where combinations of countless predatory national trade policies with import restrictions, export subsidies, exchange rate manipulation, credit and transportation subsidies. All are designed to insulate national economies and interests from free market forces. Through these practices, nation's transfer the inefficiencies of their national policies upon world trade competitors via the export route, and upon their domestic consumers via import tariff barriers.

Such trade distorting mechanisms are counter-productive. They create the element of uncertainty in world markets. They destabilize these markets by impeding the free flow of goods, by disrupting supply, demand, production cycles, and by distorting the real value of goods. This instability retards long term economic growth and it is that growth which is essential to a healthy world economy and expanded world trade.

IMPACT UPON SMALL AND DEVLOPING NATIONS

Tragically, instability in world trade impacts the small and developing nations most severely. It is these nations whose production base is both narrow and limited. If world markets are depressed for their particular export commodities not only do their particular economies suffer, but their ability to generate foreign exchange is destroyed. Foreign exchange is essential for buying power of the needed goods and services for development- primarily agri-products.

Nowhere is this more dramatically illustrated than in the impact of EEC sugar practices. The EEC subsidized in 1982-1983 exports of 2.5 million metric tons with an average export refund of U.S. 19¢/lb.. The average world price of sugar was depressed to $7.3 ¢/lb for refined sugar- a level below the cost of production in all sugar producing nations. Such "dumping" wreaks havoc upon their economies and their ability to generate foreign exchange.

U.S. PAST RESPONSE

To date, the U.S. response to these predatory practices has generally been one of weakness and hopeful passivity. Such a response only invites the aggression and hostility we seek to avoid. In today's environment our "free trade" concepts are unworkable. While "free and open" trade is a worthy long term objective, interim mechanisms and programs must be developed to insure our rights in the marketplace and prevent further market share erosion.

Survival against predatory trade practices is a matter of strength. While strength alone may not be enough to uncouple all the predatory practices, without it, there can be no effective negotiations or diplomacy directed toward that end.

IMPACT UPON THE U.S. ECONOMY

The general lack of a responsive action to these predatory practices has had a severe impact upon the U.S. economy. These practices have been particularly blatant in the value-added product sector. It is that sector which generates the greatest benefits to the economy in terms of gross output, jobs, personal income, and federal tax revenues.

It should be noted that the U.S. processor is the farmer's most reliable export outlet. When 100 pounds of flour is exported, 2.3 bushels of U.S. wheat is effectively exported. 48 pounds of soybean meal or 11 pounds of oil effectively exports 60 pounds of soybeans. 14.5 # of gluten feed exports 56 # of U.S. corn.

In most instances, the loss of value-added markets are not offset by gains in raw commodity exports. They represent additional markets for U.S. producers.

Between 1969 and 1981 the U.S. share of world trade increased dramatically (20% to 39%) in terms of volume. But the value of that trade stagnated at a modest 3%. Stated differently, 39% of the world trade originated from the U.S. while the value of that trade was only 18%. Conversely, our trade competitors exported 60% of the volume which generated 82% of the value in world trade.

Clearly, low-value raw commodities dominated the export picture. They clearly reflect our status as a "colonial" in agri-product trade.

Failure to maximize the economic benefits which accrue to the economy through value-added exports has severely impacted the U.S. economy. When our comparative advantage is destroyed by trade distorting practices of foreign competition we have effectively transferred jobs and all the economic benefits of adding value "offshore."

THE RATIONALE FOR PREDATORY PRACTICES

Nations aggressively seek export markets for their value-added production for a variety of reasons. It may be to expand the income and employment payoff on the production of bulk farm products. It may be a trade off between higher inflation, lower employment, or social instability. It may be to market the products of underutilized processing capacity, thus helping to realize significant economies of scale and capture the benefits of adding value in highly capital-labor intensive food processing. Finally it might be to generate foreign exchange earnings or capitalize on the comparative advantage in the production of a specialty crop.

Whatever the reason or reasons, nations are willing to invest in and take any measures to protect their industries and accomplish their goals- albeit at the expense of others.

Nowhere is this better illustrated than in the EEC. The EEC is the world's largest and fastest growing exported of value-added products with a growth rate of 20% per annum. Of 29 major value-added product categories in world trade, the EEC is top ranking in all but three. In beverages,dairy products, meats, fruits and vegetables, the EEC accounts for 33-75% of world trade.

They are the largest exporters of poultry, butter, milk products,wheat flour,cheese,egg products, and wine. They have replaced Argentina and Australia as the leading exporters of beef and are second only to Cuba in the export of sugar.

Poultry exports are subsidized at 21.7% of product value; wheat flour @ 37.3%; butter and milk @ 94%; cheese @ 94%; beef @ 110.6% eggs @21.7% and wine @ 2.9%. This does not include special financial arrangements, hidden rebates,or transportation subsidies.

It has been stated that they have no other choice for the sake of their economies but to expand their value-added export markets by any means necessary. But pursuing a growth rate of 20% per year and capturing by far the dominant portion of world trade at the expense of other competing nations far exceeds any wide latitudes of discretion, or concern for trade competitors.

IMPACT UPON THE U.S. ECONOMY

The United States is the major competitor for world value-added markets. As such, the predatory practices in world trade impact us the most. The degree of that impact is best illustrated by considering one industry and certain selected products.

SOYBEAN PROCESSING

Soybean processing is a $10 billion industry. Between

1973/74 and 1980/81, the U.S. share of world soybean meal exports declined from 78% to 39%; the share of soybean oil from 64% to 24%. Crushing margins declined from 72 ¢/bu to 23 ¢/bu. Unit operating costs have doubled and capacity utilization has declined from 83% to 71%.

VEGETABLE OIL

81% of the world trade in vegetable oil is subsidized. Between 1974 and 1984, world oil production has increased at an annualized rate of 1.5 million metric tons. Exports of oil have increased at an annualized rate of 639 thousand metric tons. At 13.3% of world production, U.S. oil exports would be expected to expand at an annualized rate of 85 thousand metric tons. In fact, U.S. exports are growing at a rate of only 6.6% or 42 thousand tons.

Less than 25% of the annual increase in U.S. productive capacity has been exported. More than 45% of the increase in foreign output is exported.

Much of the market share erosion has been created by Brazilian trade policies designed to promote value-added oil and meal in lieu of raw soybean exports; Spain's oil import quotas and export subsidies designed to protect its olive oil industry; Portugal's unfair trade practices designed to expand its crushing industry; Agrentina's export tax policies which encourage value-added versus raw exports; Malaysia'a differential export taxes and financing for palm oil exports; and Canada's crushing and transportation subsidies.

Quantitatively this market share loss represents 500 thousand MT per year plus subsequent world market growth of 6.6% per year.

The economic impact of this loss to the economy is:

Gross Output: $ 1.9 billion
Jobs: 34 thousand
Tax Revenues: $ 61 million = $122.00 ton

U.S. oil producers are non-competitive by between $70-$100 per ton. A U.S. counter subsidy of $100 per ton would generate $122 ton in tax revenues from the economic activity generated. This represents a cost/benefit ratio of 1.74 to 1. Additional benefits in terms of additional jobs and reduced foreign trade balances would also accrue.

In this instance, oilseed processing would be returned from "offshore" to "domestic." An expanded vegetable oil program to lesser developed countries through an expanded PL 480 program would represent new demand and as such the economics are different.

500 thousand MT of additional PL 480 business would create additional demand for 100 million bushels of soybeans requiring an additional 3.3 million acres of production. That acreage would be diverted from acreage currently under burdensome feedstuff production. In terms of corn this represents a 350 million bushel drawdown and with it all the direct and indirect government costs associated with it.

The economic scenario would be as follows:

* Gross Output:	$0.0
* Jobs:	(26000)
Reduced Storage Costs (@30¢/bu)	$105 million
Reduced Target Price Payments: (3 bil.bu @ 25 ¢/bu)	$750 million
* Tax revenue generated:	$(8)million
Total	$847 million = $1694 per MT

*A net out of the benefits gained from additional soybean production and product exports less raw corn production benefits from the acreage switch.

The cost/benefit ratio for this program would be 1.6-1.

SOYBEAN MEAL

Brazil effectively subsidizes exports of soybean meal to double the income and employment gains of their soybean production and to generate foreign exchange earnings.

Between 1973 and 1983, the U.S. share of world soybean meal trade declined from 78% to 38%. This translates into a 6 million metric ton market share loss.

WORLD NET EXPORTS
(Mil MT)
SOYBEAN MEAL

CROP YEAR	73-74		82-83	
	Vol.	Share	Vol.	Share
Brazil	1.4	22%	8.2	55%
Argentina	-	-	1.6	9%
Other Foreign	-	-	0.8	5%
Total Foreign	1.4	22%	10.6	62%
U.S.	5.0	78%	6.4	38%
TOTAL	6.4	100%	17.0	100%

U.S. economic loss:

Gross Output:	$ 6.1 billion
Jobs:	103 thousand
Federal Taxes:	$190 million =$31.60MT

SUGAR

High price support levels within the EEC has created sugar surpluses of six million tons. Much of this surplus is being dumped into world markets at current prices less than one fourth the cost of production wreaking havoc upon the sugar producing nations. EEC sugar subsidies exceed $1 billion per year. It is estimated that EEC policy has reduced world sugar prices by $300 MT or $7.8 billion- more than all U.S. foreign economic aid.

Economic Perspectives Inc. evaluated the impact of sugar subsidies upon the U.S. economy. It concluded that, in the absence of those subsidies, U.S. refined sugar prices would be $15.3 ¢/bu higher than the '82 averages; that corn demand would increase by 153 million bushels; and that corn prices would rise by about 9 ¢/bu..

While the primary impact is upon sugar producing lesser developed nations the impact to the U.S. economy is also severe.

153 million bushels of additional corn converted to corn sweeteners would generate the following:

Gross Output:	$ 7.4 billion
Jobs:	63 thousand
Tax Revenues:	$285 million
Reduced Target Price Payments (3 bil bu.)	$270 million
Reduced Storage Payments	$ 46 million
Total	$601 million= $339 MT

GLUTEN FEED

Through concessional trade-offs made during previous GATT negotiations, gluten feed and soybean meal were to enjoy duty and quota free access to E.C. markets. Today the E.C. is proceeding through the GATT process to place a quota upon gluten feed entering the Market.

U.S. GATT negotiators have taken a firm stand with the E.C. regarding this issue and hopefully will reject any form of restitution which the E.C. might offer to effect a gluten feed quota.

A three million ton quota would deny the U.S. a market for about 400 thousand tons of feed. If enacted it would cost the economy:

Gross Output:	$1.9 billion
Jobs:	40 thousand
Tax Revenues:	$ 74 million =$185 MT

POULTRY:

Between 1976 and 1982, the U.S. share of world trade in poultry declined from 22% to 15%. The EEC share grew from 19% to 31%; the Brazilian share from 12% to 18%. Other country market sharedeclined from 57% to 36%. The U.S. market share declined when world market growth rate reached 13% per year.

The market share gain by the EEC and Brazil are the direct result of subsidy mechanisms. Poultry processors have built plants specifically to meet the demand and specifications of the export market. In fact, E.C. poultry for export does not meet the standards for domestic consumption. This is in direct violation of GATT agreements.

The market share loss of 7% translates into 126 thousand MT and costs the economy:

Gross Output:	$ 2.7 billion
Jobs:	68 thousand
Tax Revenues:	$ 87 million = $690 MT=31¢/lb

WHEAT FLOUR

In 20 years, the U.S. wheat flour market share has dropped from 50% to 20%. With direct subsidies and special financial considerations, the EC world market share has risen to 67%. Overall growth in world flour trade is a flat 1.6% per year.

In absolute terms this represents a direct loss in tonnage of 2.4 million MT./year.

The loss to the economy is:

$ Gross Output:	$3.5 billion
Jobs:	76 thousand
Tax Revenues:	$513 million = $213 MT.

WHEAT MIDDLINGS

Wheat middlings are a feed byproduct produced in the dry milling of bread flour. The E.C. has recently imposed an import duty of approximately 45% of the value of the midds ($55 MT). At this level, the U.S. is effectively excluded the access to the Common Market.

The import barrier has a double edged impact upon the U.S. milling industry. First, the industry is denied access to a 200 MT outlet for millfeeds. Second, that market within the EEC is filled by European mills at a price $55 per ton higher than would otherwise be. The millfeed portion of the flour conversion is 95¢/cwt. higher than would otherwise be; thereby permitting European mills to offer flour into export markets at 95¢/cwt. cheaper than would otherwise be.

The lost 200 thousand MT of business costs the U.S. economy:

Gross Output:	$963 million
Jobs:	20 thousand
Tax Revenues:	$ 36 million = 180 MT

A recent amendment to the Canadian Western Grain Transportation Act reclassifies the U.S. as an export market. Wheat can be shipped for conversion into flour at dramatically lower export rates versus domestic. The low cost wheat and the reclassification of the U.S. as an export market permits Canadian millfeeds to be dumped into the Pacific Northwest at prices as much as $18.00 ton cheaper than Canadian feed manufacturers are paying just across the border.

PASTA PRODUCTS

Pasta represents a classic example of an E.C. subsidy targeted to penetrate directly into U.S. domestic markets in direct competition with U.S. manufacturers. Italian pasta is imported already packaged for the grocery shelf.

Thus, all the value added benefits are generated "off shore."

A GATT panel decided in favor of a U.S. [illegible] protest against these subsidy practices. Yet, the GATT commission refused to accept the findings of the panel and Italian pasta continues to flood the U.S. market.

Subsidies permit the Italians to underprice U.S. produced pasta by 24 ¢/lb on the grocery shelf.

Italian market shares have been increasing at a compound rate of 33% per year. By 1989, if unchecked, they will have captured 20% of the U.S. market.

In 1975 pasta imports from the E.C. were 100,000 cwts.. 1984 imports are projected at 1 million cwt. - a tenfold increase.

Italian pasta is made from Italian durum wheat. As such the U.S. durum producer has lost a market for 2.34 million bushels or 2.3% of his crop.

Italian imports cost the U.S. economy:

Gross Output:	$527 million
Jobs:	6 thousand
Tax Revenues:	$ 28 million =$28 cwt.

TOTAL ECONOMIC IMPACT-SELECTED PRODUCTS

Of the 8 value-added products considered, world trade distorting mechanisms have cost the U.S. economy 12.5 million MT of business; $25 billion in gross output; 384 thousand jobs; and $ 2.4 billion in Federal tax revenues and other benefits. This equates to $192 per MT in lost treasury benefits.

A treasury payback of $192 per ton from value added exports is sizable and represents a clear indication of why nations are willing to reinvest part of that return to gain access to world markets through the subsidy route. It is good business. The problem is that gaining market access in this manner is at the expense of other world trade competitors without subsidy mechanisms.

It is also clear that in developing programs and policies for the 1985 Farm bill to expand exports and lost market share, there would be little or no taxpayer outlay. The expenses to gain market access would be funded from the tax revenues generated.

Regaining the lost market share in just these 8 products would have a favorable impact upon the foreign trade balance of $ 4 billion.

SUMMARY

	Tons (000 MT)	Gross Output $ Billion	Jobs (000)	Tax Revenue $ Million	Other Benefits $ Million
Vegetable Oil					
a) Commercial	500	$ 1.9	34	$ 61	$ -
b) PL 480	500	0.0	(26)	(8)	855
Soybean Meal	6000	6.1	103	190	-
Gluten Feed	400	1.9	40	74	-
Sugar	2300	7.4	63	285	316
Poultry	126	2.7	68	87	-
Wheat Flour	2400	3.5	76	513	-
Wheat Middlings	200	1.0	20	36	-
Pasta	45	0.5	6	28	-
Total	12471	$ 25.0	384	$1266	$1171

Treasury Cost: $2.4 billion

CONCLUSION:

The United Stated has, in the past, been able to be the world adjuster of supply/damand equations and to unilaterally absorb the pricing shocks associated with supply imbalanceswhen its relative position in world trade was greater; when commodity prices were lower; when market volatility was less; and when world markets were expanding.

Today we simply cannot afford this role. The impact upon our economy and its industries is too great. Losses of $ 25 billion in gross output, 384 thousand jobs, and $2.4 billing in treasury benefits simply cannot be ignored.

The entire agri-infrastructure is dependent upon exports for its health and viability. And, the nation's economic welfare is tied to a healthy agricultural and food complex.

The time has come to recognize the realities of the global marketplace. We must recognize that government and private entity collaboration are deeply ingrained in the national food policies of nations; that those nations are reluctant to change those policies; and that to date we have been unable to effect changes toward "free and open trade."

Perhaps government/private entity collaboration is already an integral part of the global free enterprise system. If so we should accept this reality and develop programs and policies to insure our access to the world market.

Massive,indiscriminate counter subsidies would probably depress global prices to disaster levels. However, the use of carefully targeted arrangements, such as are authorized under PL 480, can be a potent, practical vehicle to deal with the entire subsidy issue. Targeted response would send the signal that the U.S. is committed to protect itself in the marketplace. Such a signal or series of signals would represent a show of strength and intent which could lead to serious negotiations toward uncoupling all trade distorting practices. It might force all nations to rethink their national food policies and adjust them in such a manner as create an orderly global marketplace- one in which there is equity for everyone.

Free and open trade is a worthy long term objective which should be pursued. But we should not pursue it so blindly that we erode the structure of our largest business, our largest employer, our largest asset, and our major source of foreign exchange earnings- the agricultural and food complex.

LABOR-INDUSTRY COALITION FOR INTERNATIONAL TRADE

[illegible]

AT&T

Bethlehem Steel

Amalgamated Clothing and Textile Workers Union

Communications Workers of America

Corning Glass Works

International Union of Electrical, Radio and Machine Workers

International Brotherhood of Electrical Workers

American Flint Glass Workers Union

The BF Goodrich Company

Industrial Union Department, AFL-CIO

Ingersoll Rand Company

International Ladies' Garment Workers Union

International Association of Machinists and Aerospace Workers

United Paperworkers International Union

United Rubber Workers of America

The Signal Companies, Inc.

St. Joe Minerals Corporation

United Steelworkers of America

W. R. Grace & Co.

Westinghouse Electric Corporation

LICIT

IMPACT OF EEC SWEETENER POLICIES ON U.S. AND WORLD PRODUCERS

SUMMARY

BY
ECONOMIC PERSPECTIVES, INC.
6723 WHITTIER AVE., SUITE 101
MCLEAN, VIRGINIA 22101
703 734-8787

MARCH 1985

March 4, 1985

IMPACT OF EEC SWEETENER POLICIES ON U.S. AND WORLD PRODUCERS

SUMMARY

The European Economic Community (EEC) only recently has become a major sugar exporter. From a net importer in 1975, it now is the dominant exporter in the world free market. As a result, EEC policies have vast impacts on sugar prices, and on sweetener producers in the United States and the world.

This study is an analysis of some of the major effects of EEC's sugar policy. It is less a prediction of an outcome than an illustration of the relative importance of EEC policies on world sugar markets and on domestic producers of sugar, HFS, and corn. It recognizes that the market impacts of such a policy have accumulated over many years and are impossible to measure in their totality. Nevertheless, the study examines economic conditions at one point in time, and attempts to measure the impacts of the policy by measuring changes that reasonably could be expected in the absence of EEC exports.

The EEC's current sugar regime reflects a policy of maintaining and protecting high internal sugar prices initially begun to insure self-sufficiency in production. However, that policy has resulted in the EEC's shift from a traditional importer to a large and growing exporter (Chart 1 and Table 1). Because it has high production costs and no economic advantage in production relative to the major sugar producing regions of the world, its position as a dominant world exporter has been achieved only at great expense.

The EEC policy has three important economic effects. Its extremely high price structure (which must be protected by very high import levies) has led to production far above amounts that otherwise would be forthcoming. At the same time, the high consumer prices have discouraged consumption. These two

Chart 1. EEC Sugar Production, Consumption, and Trade

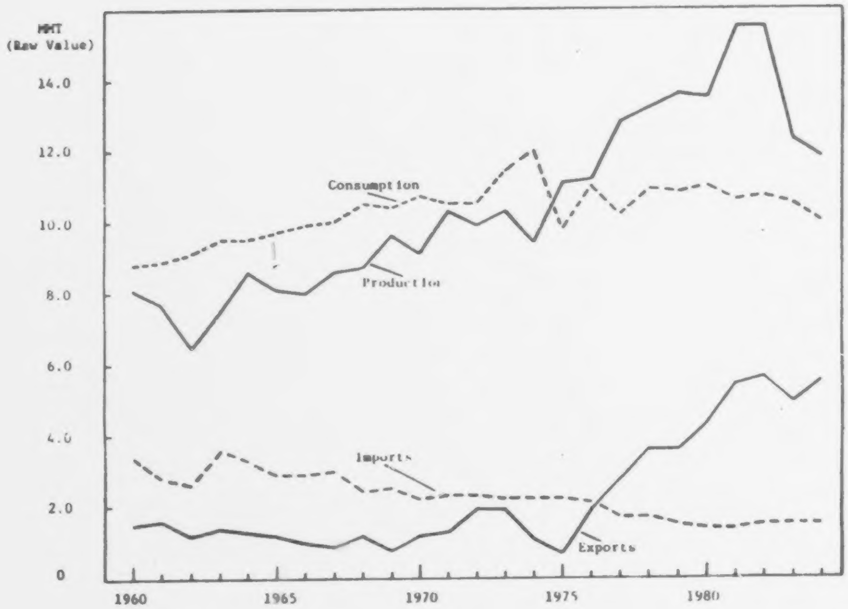


Table 1. Net Exports of Sugar to the World Free Market

Exporting Country	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
	- - million metric tons, raw value - -										
EEC		1.2	2.4	3.3	3.4	4.3	5.4	5.6	4.9	5.5	4.4
Brazil	1.7	1.3	2.5	1.9	1.9	2.7	2.7	2.8	2.8	2.9	3.0
Australia	2.0	2.6	3.0	2.0	2.0	2.4	3.0	2.5	2.4	2.6	2.8
Cuba	1.7	1.4	1.5	2.0	2.1	2.2	2.2	1.7	1.7	1.7	1.7
Philippines	1.0	1.5	2.6	1.1	1.1	1.8	1.3	1.3	1.0	1.0	1.0
Thailand	0.7	1.1	1.7	1.0	1.2	0.5	1.2	2.0	1.4	1.4	1.4
Others	6.3	6.4	7.2	6.2	6.6	5.8	5.0	5.8	6.4	5.4	6.2
Total	13.4	15.5	20.7	17.5	18.3	19.4	20.6	21.6	20.5	20.5	20.5
	- - percent of free market - -										
EEC	0	8	11	19	19	22	26	25	24	27	21
Brazil	13	8	12	11	10	14	13	13	14	14	15
Australia	15	17	14	12	11	12	14	12	12	13	14
Cuba	13	9	7	12	12	11	11	8	8	8	8
Philippines	7	10	12	6	6	9	6	6	4	5	5
Thailand	5	7	8	6	7	2	6	9	7	7	7
Others	47	41	34	35	36	30	24	27	31	26	30
Total	100	100	100	100	100	100	100	100	100	100	100

Source: Historical data from ISO.

effects in combination have resulted in production of substantial quantities of sugar in excess of consumption requirements. To avoid holding the large surpluses that are generated, the EEC must provide large export subsidies to move sugar into world markets. By that means, and in spite of the lack of an advantage in production, the EEC has greatly increased its share of the world "free" sugar market from zero in 1975 to more than 27 percent in 1984.

In 1984, the huge world surplus sugar stocks were more than 50 percent of expected consumption, the result of recent policy changes in the EEC and elsewhere. The world price of raw sugar fell below four cents per pound during the year and averaged only 5.4 cents per pound (raw value). However, the EEC exported more than 5.5 mmt during the year. Had they expected no sugar in 1984, the world price would have been substantially higher, perhaps more than 15 cents per pound even with the large world sugar stocks. Such a change could have been expected to allow the United States to drop the import quotas imposed in 1982 and return to the use of fees and duties to protect the loan program and hold prices at about the actual 1984 levels.

Had world sugar stocks been near trend levels at the beginning of 1984, the absence of EEC exports from the market would have meant world refined sugar prices about 24 cents per pound higher, and U.S. refined sugar prices about 9.43 cents higher than the 1984 average (Table 2). U.S. sweeterner producers' revenues would have been more than $2.1 billion higher and corn sweetener producers' revenues $1.2 billion above the 1984 levels. U.S. quota restrictions would have been unnecessary.

The EEC sugar policy significantly affects HFCS production and corn prices as well. With world sugar stocks at trend, the absence of EEC exports would have been associated with U.S. refined sugar prices 9.43 cents per pound higher than the 1984 average. Over the intermediate term, such an increase would have the potential to facilitate increased HFCS competition. By the end of the decade production likely could be as much as 53.4 million cwt above 1983 output. Such an increase would mean about 160 million bushels more corn used in HFCS production annually and higher corn grower sales of as much as $1.2 billion each year.

Table 2. Impact of EEC Exports, 1984

Item	1984 Stocks Levels		World Stocks at Trend 1/	
	Actual	Absent EEC Exports	With EEC Exports	Absent EEC Exports 2/
		- - cents per pound - -		
World Sugar Prices				
Refined	9.40	19.19	21.60	33.80
Raw	5.43	15.15	17.20	28.50
U.S. Sugar Prices				
Refined	28.04	28.04	28.04	37.47
Raw	21.80	21.80	21.80 3/	30.53 4/
Difference from 1984 Average			---	9.43
On U.S. Producers				mil $ 5/
Sugar (5.18 mst)				977
HFCS (4.30 mst)				811
Other Corn Sweetener (2.54 mst)				347
Minor Caloric Sweetener (0.17 mst)				14
				2,149

1/ 45.2 mmt, raw value, in 1984.
2/ Comparison assuming equilibrium following the changes specified, reflecting normal stock levels at the beginning of the year and the absence of EEC exports.
3/ World raw sugar price, duty, and 1.4 cents per pound freight, insurance, and handling, plus fees as necessary to protect the loan program.
4/ World raw sugar price plus minimum duty of 0.625 cents per pound and 1.4 cents per pound freight, insurance and handling.
5/ Assumes spread between sugar and HFCS is unchanged, and other sweetener prices increase proportionally less than sugar.

A 160 million bushel increase in the commercial use of corn would substantially reduce government program costs. Under FY 1985 crop conditions, it could reduce the cost of CCC loans by $281 million, storage payments by $33 million, and target prices by $200 million, a total of $514 million.

The absence of EEC exports from the world sugar market would have a major impact on traditional sugar exporters, especially the developing nations in Central America and the Caribbean (Table 3). Even with the large 1984 stocks, revenues of traditional sugar exporters would have been $2.6 billion higher had the EEC not been in the market in 1984. Had 1984 beginning world stocks been a normal level, their export revenues would have approached $6.7 billion. For the Central American and Caribbean nations alone, annual revenues could have been $600 million higher, for South America $2.1 billion, and for Africa more than $728 million.

Table 3. Value of Sugar Trade, 1984, Normal Beginning Stocks

Origin	Total		Change
	Actual	No EEC Exports	
	- - million dollars - -		
EEC	699	0	-699
Other Caribbean	362	686	324
Central America	306	574	268
Canada-Mexico	14	62	48
South America	781	2,870	2,089
Africa	522	1,250	728
Oceania	460	1,816	1,356
Asia	508	2,085	1,577
Other	137	917	780
Total World	3,789	10,260	6,471

Executive Summary

The President's Task Force on International Private Enterprise

December 1984

Executive Summary

The President's Task Force on International Private Enterprise

In May 1983, at a time of severe international economic turbulence, the President established the President's Task Force on International Private Enterprise. The President requested that the Task Force identify ways to strengthen the economies of developing nations. In particular, the President asked the Task Force how U.S. foreign assistance could be used to stimulate private enterprise development and promote investment in and trade with developing countries.

The following summary includes the major findings and recommendations of the Task Force.

Executive Summary

The United States now faces the challenge of leading the world to a new era of prosperity created, in significant part, by unleashing the dynamism of the private sector in the Third World. Meeting this challenge successfully is a matter of our own long-term national security and is the direct requirement of a world grown more interdependent. As they have in the past, U.S. economic policies will continue to reflect and be dictated by traditional humanitarian concerns.

We believe that the United States and developing countries share a vital interest in Third World economic development, that economic growth can best be achieved through the development of the private sector, and that economic growth provides a necessary base for long-term political stability.

Among the Task Force's general recommendations are the following.

☐ **Elevate international economic policy to a level comparable to national security.**

In the world of the twenty-first century, the security of the United States and of developing nations will depend increasingly on how well our economies interact. One of the critical determinants of our security will be the degree of our success in sharing our economic strength with the developing world. This will also require giving heightened significance to international economic policy and devising ways to share our economic know-how with developing countries.

☐ **Establish an Economic Security Council.**

Responsibility for the formulation of international and domestic economic policy is fragmented, with portions scattered throughout the U.S. Government. A well-coordinated U.S. economic policy would mean more jobs, increased exports, and increased stability at home and abroad. We propose the creation of an Economic Security Council, responsible for formulating, coordinating, and integrating international and domestic economic policies. Some of the matters with which such a council would deal are the debt crisis, trade and agricultural policy, technology transfer, and foreign assistance.

☐ **Expand Opportunities for Private Enterprise.**

The private sector in developing countries is hampered not only by the lack of capital and the lack of technology and management skills that accompany direct investment, but also by the absence of positive government policies toward entrepreneurship. By urging, encouraging, and using our resources to help developing countries adopt policies that attract foreign direct investment and by helping businesses identify investment opportunities in the Third World, we can make a crucial contribution to the economic development of those countries. The Task Force's *Private Enterprise Guidebook* provides specific advice on how to use U.S. resources to attract foreign and local investment.

☐ **Reorient U.S. foreign aid programs.**

Perhaps the greatest paradox in our foreign aid programs has been that while U.S. economic success is based upon private enterprise, we have done far too little to help developing countries attract private enterprise, trade, and investment. U.S. foreign assistance programs should substantially expand their efforts to help developing countries adopt policies that will strengthen the opportunities for private enterprise. To the maximum extent feasible, the U.S. Government should not channel its foreign assistance resources to governments, but to the private sector in developing nations. For the mutual benefit of the United States and developing countries, the U.S. Government should also integrate its foreign assistance and trade programs and policies to make better use of its resources. The Task Force's action brief on strengthening AID's private enterprise thrust and its *Private Enterprise Guidebook* will serve as a blueprint for this reorientation.

☐ **Press for Increased Trade Flows.**

American firms increasingly find themselves competing overseas with foreign firms that are supported by their national treasuries. Not only are U.S. companies losing large amounts of business to mercantilist nations that provide heavy subsidies to their firms, but these practices distort the whole pattern of international trade to the detriment of the United States, developed countries, and developing countries alike. In fact, we believe the practice of "mixed credit" trade subsidies has become a ~~major~~ threat to international private enterprise. To protect U.S. firms and the free enterprise system, we recommend that the United States fight fire with fire. Specifically, we believe that the Administration should make sufficient mixed credit resources available in order to convince other nations that such practices are not in anyone's "best interest." This will press our foreign competitors to the negotiating table and bring an end to such predatory practices. In Part V of this report we recommend that the Agency for International Development (AID) and the Export-Import Bank (Eximbank) blend their resources and that, if necessary, Eximbank use the full extent of its authority. This could amount to a mixed credits program of several billion dollars.

☐ **Constructively use U.S. Agricultural Abundance.**

We cannot afford, financially or morally, to idle large parts of our productive farmland. Rather, we must devise ways to harness our agricultural abundance so that we can increase exports from the United States and alleviate chronic starvation and malnutrition in the developing world. Food can also be used to ease the pressing foreign exchange needs of Latin American, Asian, and African nations caught in the international debt crisis. The U.S. Government can provide large amounts of food to these countries on a concessional basis to enable them to use their limited foreign exchange to meet other objectives. The Public Law (P.L.) 480 Program is one of the President's most effective tools. We recommend doubling the program. Given the current costs of farm subsidy programs, the impact of this increase would be a net reduction in the Federal budget.

In designing a strategy to address current crises and long-term economic development needs, the Task Force has been guided by the following precepts.

☐ Market-oriented economies work, excessively planned economies do not.

☐ The United States has an important role to play in leading the world toward balanced and equitable economic growth.

☐ A free and open trading system offers the greatest hope of achieving widely shared economic growth and prosperity. However, U.S. industry and agriculture must be able to compete with the terms offered by mercantilist nations until such time as we can meet our competitors on a level playing field—in fair and open competition.

☐ United States agricultural abundance must be harnessed more effectively to address the human and development needs of the people of the Third World.

Specific Findings and Recommendations of the President's Task Force on International Private Enterprise

The following findings and recommendations are discussed in the report that follows. They are the result of substantial research and the subject of extensive deliberation by members of the Task Force over the past several months. If adopted, our recommendations will strengthen the economy of the United States and other developed and developing nations.

THE IMPORTANCE OF PRIVATE ENTERPRISE AND INVESTMENT TO DEVELOPMENT

Finding: Countries that fail to create conditions—including appropriate laws and policies—that will attract investment will relegate themselves to slow growth. At the present time, there is no central source of advice to help developing countries foster the conditions necessary for private sector growth.	**Recommendation:** The United States, working with other donor nations, developing countries, multilateral institutions, and private business, should establish a Private Enterprise Institute that will serve as a research center to advise developing countries on how to create those conditions necessary to attract investment and foster trade.
Finding: New foreign investment will be difficult to attract for many debt-ridden LDCs as long as insufficient foreign exchange is available to the private sector.	**Recommendation:** The United States should take the lead in assuring that private needs for credit and foreign exchange in LDCs are not pushed aside by preferred access of the public sector.
Finding: The United States and other donors do not make sufficient effort to increase private investment and improve the investment climate in developing countries.	**Recommendation:** The United States should strongly encourage international dialogue on ways to support increased foreign direct investment.
	Recommendation: The United States should substantially increase its support of private investment activities in developing countries.
Finding: In order to increase foreign investment, developed and developing countries need to adopt uniform standards for host country and investor responsibility and conduct.	**Recommendation:** The United States should encourage developing nations to negotiate bilateral investment treaties. The United States should assign priority in its aid programs to those countries that sign such treaties.

Finding: Expanded investment insurance (or guarantee) is a key to increasing investment in developing countries.	**Recommendation:** Overseas Private Investment Corporation (OPIC) funding and insurance capability should be substantially increased and its mandate broadened to include a full range of financing and services to U.S. business, large and small.
	Recommendation: The United States should support a multilateral investment guarantee program administered by the World Bank.

FOREIGN ASSISTANCE PROGRAMS AND PRIVATE ENTERPRISE DEVELOPMENT

Finding: The U.S. Government does not sufficiently encourage or assist recipient developing countries in making the policy changes necessary to allow private sector growth.	**Recommendation:** The United States should sharply increase its efforts to guide developing countries toward market-oriented policies; it should reward those countries that adopt strategies that will lead to a positive climate for business and investment.
	Recommendation: U.S. food assistance should be used to a greater extent as an incentive for developing countries to adopt market-oriented policies that encourage the private sector to increase agricultural production.
Finding: U.S. foreign assistance programs are often required to address problems other than those related to long-term stability and economic growth.	**Recommendation:** The economic component of U.S. foreign assistance programs should have a higher national priority.
Finding: The links between our foreign assistance program and U.S. foreign trade are inadequate.	**Recommendation:** The scope and financing of the Trade and Development Program (TDP) should be expanded.
	Recommendation: TDP techniques should be applied to other foreign assistance programs, specifically those carried out by AID, to the maximum extent possible.

	Recommendation: U.S. foreign assistance resources should be used to build up the trading capacity of developing countries.
	Recommendation: U.S. foreign assistance resources should be used to assist in China's modernization process.
	Recommendation: U.S. foreign assistance agencies—such as AID, OPIC, and TDP—should package their financial and other resources to promote greater two-way trade between the United States and developing countries.
Finding: In implementing its agricultural development policies, AID has not given private agribusiness activities the attention and support they deserve.	**Recommendation:** Private sector efforts to form private sector agribusiness development corporations should be encouraged and supported.
	Recommendation: Developing country agricultural entrepreneurs should be supported by qualified U.S. executive-managerial and technical personnel "on loan" from the private sector to assure the ongoing progress of companies and individuals being financed with U.S. foreign assistance funds.
Finding: The international financing institutions play a constructive role in Third World development.	**Recommendation:** The United States Government should utilize its resources to support broad economic changes in developing countries and, where appropriate, coordinate its efforts with those of the International Monetary Fund, the World Bank, and the International Finance Corporation (IFC).
	Recommendation: The United States should continue to support the multilateral development banks' efforts to support private enterprise development.

Finding:
The breadth and scope of AID's private enterprise activities are too limited. In order to expand them, AID needs a clearer mandate, improved skills, and greater flexibility.

Recommendation:
AID's congressional mandate, its policies, its programs, and its organization must be revised to reflect greater private sector emphasis.

Recommendation:
AID should turn to the U.S. business community to assist it in developing practical modes of business-government cooperation.

Recommendation:
The U.S. Government, to the maximum extent feasible, should channel its foreign assistance resources through the private sector and not through governments: AID should substantially increase its support of private intermediate credit institutions (ICIs).

Recommendation:
AID should increase its equity financing through ICIs.

Recommendation:
AID should serve more as a broker between U.S. businesses and prospective overseas partners by providing inexpensive, current, and easy-to-use information on the investment climate and operating conditions in developing countries.

Recommendation:
AID should support the formation of trading companies and other business brokering institutions that have developmental potential.

Recommendation:
AID should encourage joint undertakings between businesses and private voluntary organizations in developing countries.

Recommendation:
AID should streamline its administrative and procurement processes.

Finding: Training, in various forms, is one of the most effective long-range means of promoting development. Fulfilling training needs offers the United States a significant opportunity.	**Recommendation:** The United States should significantly expand U.S.-based training and place stronger emphasis on private sector participation and needs.

THE FORMATION OF U.S. ECONOMIC POLICY

Finding: In order to cope with new and changing circumstances, a new institutional structure is needed to ensure better formulation and coordination of U.S. international and domestic economic policy.	**Recommendation:** The President should establish an Economic Security Council (ESC) to formulate and coordinate domestic and international economic policy. **Recommendation:** The President should designate an Assistant to the President for Economic Affairs who would participate in the Economic Security Council.
Finding: Both legislatively and administratively, our foreign assistance programs suffer from confused mandates, divided responsibility, and often from a perception that economic development has a low priority.	**Recommendation:** There must be greater, more regularized consideration of developing country issues in the policy deliberation process. **Recommendation:** Changes must be made in AID's mandate and organization in order to improve the effectiveness of foreign assistance programs.
Finding: Responsibility for the U.S. Government's trade policies and programs is fragmented among several government agencies. Policies and programs do not operate within an overall strategy aimed at benefiting both the United States and developing countries, nor are they designed to address both U.S. trade objectives and broader U.S. economic objectives.	**Recommendation:** The U.S. Government must develop an aggressive, consistent trade policy that mixes aid and trade resources, enables U.S. firms to be more competitive in world markets, and meets the challenges posed by the growing governmental role in world competition. **Recommendation:** The United States must link its trade and foreign assistance programs. **Recommendation:** The United States should consider ways to give higher priority to the need for a freer and more open international trading system and continue to press for

	a new round of multilateral trade negotiations. This new round should include adopting a trade in services code, the application of trade rules to middle-income developing countries, and strengthening enforcement procedures against government-subsidized trade.
	Recommendation: The authority of the United States Trade Representative (USTR) as trade policy negotiator and manager should be strengthened and expanded.
Finding: The United States needs a more coordinated policy to integrate domestic agricultural programs, food assistance programs, and agricultural trade programs.	**Recommendation:** The United States must integrate its agricultural trade, food aid, and domestic farm policies. **Recommendation:** The Administration should seek to better relate U.S. response to LDC food and domestic security requirements.
Finding: Some U.S. Government measures have discouraging or disadvantageous effects on American firms that are involved or might become involved in long-term relationships with private enterprise in developing countries.	**Recommendation:** The U.S. Government should coordinate more effectively its efforts to assure that U.S. laws and regulations reflect greater sensitivity to structural changes in the international marketplace.

TRADE AND FOOD ASSISTANCE

TRADE

Finding: The United States has not adopted a strong enough stance in its negotiations to stop foreign governments from using unfair methods of subsidizing export finance.	**Recommendation:** The United States should use aggressively the mixed credits authority of the Export-Import Bank (Eximbank) to counter competitors' mixed credit offers. **Recommendation:** AID should also use its limited mixed credit authority, although the Export-Import Bank will be the major source of mixed credit financing.

Finding:
The current debt crisis in the developing countries requires close cooperation between the U.S. private and public sectors to assure that adequate trade financing is made available.

Recommendation:
U.S. Government foreign credit programs should operate under consistent guidelines.

Recommendation:
As part of an integrated trade policy, the participation of the U.S. private sector in countertrade should be facilitated when it is in the best interest of the United States.

FOOD ASSISTANCE

Finding:
Many developing countries face chronic food shortages that will undermine their political stability and economic development.

Recommendation:
Food aid should be at least doubled to help avert starvation, alleviate poverty and malnutrition, expand developing country agricultural markets, and support private sector growth.

Recommendation:
A much larger share of total U.S. foreign assistance should be food assistance.

Recommendation:
Agricultural export credit programs should be significantly increased to help lessen the development impact of large food deficits and large debt burdens.

Finding:
Present U.S. food assistance programs do not emphasize private enterprise development and U.S. private sector involvement in development assistance.

Recommendation:
The U.S. Government should follow the instructions and intent of the law that most counterpart funds generated by P.L. 480 should be channeled through businesses and not through government.

The CHAIRMAN. Thank you very much, Mr. Andreas.

Mr. Roosa, would you proceed, please?

STATEMENT OF HON. ROBERT V. ROOSA, PARTNER, BROWN BROTHERS HARRIMAN & CO., NEW YORK, NY

Mr. ROOSA. Thank you, Senator.

I, too, am privileged and pleased indeed to have an opportunity to appear here today.

I think that what I have to say will dovetail reasonably well with the approach that Mr. Andreas has taken, because I let myself think backward to the time a generation or more ago when I was in the Treasury, and I used to appear before this committee, and I always talked about the dollar and the balance of payments.

So, I thought in my view at least that because that is the lynchpin of what is affecting so much of our global economic position it would be reasonable if I focused on that today.

I want to start by addressing what I think is a kind of aphorism that is circulating here—it is repeated by all of my friends who are still colleagues in the Treasury—the notion that there is nothing wrong with the exchange rate because it is a market-determined rate.

I would like to make the distinction and then proceed with a little analysis from that. There is no question that it is a market-determined rate. The fact is, however, that it is determined in a market where the dominant forces are those of capital flows where indeed a day's transactions in goods or services in trade overall might aggregate $3 billion, while the world foreign exchange markets every day have $50 to $100 billion in transactions, many of them mere paper transactions, where only margins are cleared at the end of the day and no currency actually moves. Nonetheless the volume of new transactions is so enormous that it is the capital flow that determines the exchange rate, an actual rate which is very high for the dollar in contrast with comparative prices for goods and services.

Any of us who ever have occasion to travel abroad or do any business abroad know very well that even with all the barriers and problems that Dwayne has mentioned and which need addressing, the comparison among prices is still ridiculously different.

So, I think that in terms of the basic relation of prices in this country as against the rest of the world there is a notional rate or a basic rate quite different from the actual rate that prevails.

It is because of that spread, that difference, that we are getting so many distortions, that we are getting such a flood of imports. This is one of the reasons we are getting such a flood of imports into this country. I do not mean to say that that has not been helpful in keeping down our inflation and maybe toning up the efficiency of American business, but at the same time it has certainly generated or been a part of generating this great concern and the need for protectionism that we heard discussed this morning. It is not just in the Japanese case. It is all the way around.

I think if we were to find ways of trying to close that gap, we would be making at least a partial contribution toward restoring the world economy and our own position in it, to be closer to the world we used to live in before the last 5 or 6 years.

What we have actually had in a sense is a mutation in the influences that affect our exchange rate and those of the rest of the world. Until nearly the end of the seventies, it was always reasonable to indicate that it was the way a country performed, what its balance of payments was, what its price performance was, what its GNP performance was that would determine its relationship to the rest of the world and would determine its exchange rate.

That is no longer the case. Witness the fact that we are running a $125 billion trade deficit. If any country in the days before the seventies had run a deficit of that proportion anywhere in the world, their currency would have been low, but ours is high, and the causality has been turned around.

Instead of the balance of payments determining the exchange rate, it is the exchange rate that is set by capital flows, which is determining the balance of payments. The balance of payments reflects those goods and services that really move.

So, this is the new environment in which we have to think of the way in which our role in the global economy can evolve, in which we want to try to find something to do about it.

Now, of course, Ambassador Brock was right in saying the first thing we can do about it is to get our domestic deficit clearly on a downward track. It is true, and he elided over one intermediate course, that is that a lower deficit means lower interest rates in this country, and that should help to lower the dollar.

In between, there is the fact, and one of the Treasury representatives mentioned this in testimony yesterday at the House, that if we get the deficit down, and this tends also to improve confidence abroad in the ability of our Government to handle economic affairs, that may well lead to a little more interest in capital flow here. It may even tend to push the dollar up again.

I think that is likely to be a possibility temporarily, but certainly over the longer pull a steady decline in interest rates, a narrowing in that interest rate spread which has been one of the many factors causing capital flow here or the flow into dollars in the overseas market, and that still affects the exchange rate either way, would, I think, in the end redound to the reduction of the spread between the actual or going capital determined exchange rate and the basic, real, underlying rate between the goods and services prices.

I think in order to get somewhere we are going to have to take a leaf from what Mr. Andreas has been outlining. First of all, we do need a really coordinated and high level systematic, coherent approach to economic policy within the administration.

Once we get that, I think we have to begin thinking in terms of moving beyond to get relations with other nations. Most of them, as Dwayne has indicated, are a little better organized than we are to have a systematic economic policy for pursuing their own national interest willy-nilly, come what may. We need to be in a position to be able, with the full participation of the Government in a coordinated way, to negotiate with them.

There are a number of things that can be done. I tried to review some of those in my testimony. I will not try to elaborate. If there is time, I can go into that further later on.

There are within the range of capital movements a couple of points to make. No. 1, I think it would be both impractical and certainly unwise to think that we could close this gap by turning toward any kind of capital controls.

I would further agree with Ambassador Brock this morning that it would be ineffective and perhaps self-defeating to try to do it by having a 20-percent across-the-board import duty, but I do think instead of trying in that way to manhandle what is happening in the markets, there are ways in which we can recognize where the markets are going and take advantage of other capabilities that exist to provide counterforces, to have a backflow.

There are really three things there. I will not elaborate on them, but will just mention them. One which I tried to start in the Treasury back in 1961, and which has now languished is for this country in its own longer term interests to begin acquiring and holding substantial balances of foreign currencies.

That very act in the process as we acquire them tends to help make the other currencies a bit stronger. It tends to lessen the gap. A second is that we can do more, since they are all running deficits at home to borrow for part of their needs in dollars, borrow and then convert those dollars into their own currency to meet their own home requirement.

These are situations that they have to meet anyway. This is not interfering with the market, but it is providing a return flow in which there will be a counterforce against that incessant flow of capital into the United States.

Third, around the edges of all of this there is room for intervention, despite the way in which it has been denigrated in most public comment.

The reason is, as Chairman Volcker said a couple of weeks ago, it has never been adequately coordinated, and there has never been cooperation of a systematic kind from the United States except when Paul and I were both Under Secretaries of the Treasury. We did it, but it is not done now. It is possible. It takes technique. It takes funds.

When Paul was my deputy, we built a system of swap arrangements which give us access to other currencies which we can use whenever we need it. It gives others access to dollars when they need it.

And here, what can be done additionally is occasionally to use carefully gauged and calibrated intervention to help reduce some of the erratic evidences of volatility in the foreign exchange markets which are also certainly at least troublesome, sometimes defeating to the objectives of a free and open trading system.

Well, I do not want to belabor any of these points longer, Mr. Chairman, except to have touched on them, and to say that at even more exhausting length they are all included in my testimony.

[Mr. Roosa's prepared statement follows:]

Statement prepared for submission to the
Senate Foreign Relations Committee
on March 6, 1985
by Robert V. Roosa, Partner
Brown Brothers Harriman & Co.

The Dollar and the Balance of Payments

Mr. Chairman, it is a nostalgic privilege for me to appear before your Committee today. More than a generation ago, as UnderSecretary for Monetary Affairs in the Treasury, I frequently met with this Committee to discuss the significance of the dollar and the balance of payments. Because Ambassador Brock will already have provided a comprehensive overview of the role of international trade in promoting global economic growth, I propose today to revert to my old subject. For indeed, our dollar and our balance of payments are linchpins in the performance of the entire world economy.

The world in which we discussed these phenomena in the early '60s seems, however, to be light years away. For we were then, quite appropriately, living by the same classical textbook criteria that had prevailed for a century or more:

> A country was expected to respect balance of payments discipline. A leading, industrialized country would demonstrate that discipline by so controlling its domestic budget, monetary policy, and price behavior as to maintain a balance of payments surplus, at least on trade account and often on current account. It would quite naturally then be a capital exporter, to countries whose development required a net import of capital. And the United States, as the apotheosis of this ideal, was inevitably the home of a strong currency. Indeed, since World War II and the creation of the International Monetary Fund, the non-Communist world's currency system, which is the essential vehicle for achieving and sustaining growth in the world economy, reached its operational optimum as country after country established and maintained a par value for its currency by defining its exchange rate in relation to the U.S. dollar.

But times have certainly changed. Without tracing the stages through which the United States and the Western world have moved in quick succession, I should note the key benchmarks that help to orient any discussion we can pursue today. Fixed par values for most currencies disappeared in 1973. By 1978, although the dollar was still the principal transactions currency of the IMF system, its value in relation to other currencies (as determined across the exchanges) had slid downward because the United States had begun to incur what were then unprecedentedly large balance of payments deficits, both on trade account and on current account. That the dollar should have slipped, in a world of floating exchange rates, when its balance of payments went sharply into deficit, was still fully in accord with the old rules. But then came the mutation which has to be recognized as the principal new factor in our situation today.

In September 1978, with President Carter's support, Secretaries Blumenthal and Solomon initiated a vigorous program to defend the dollar. In October 1979, a newly appointed Chairman Volcker and his colleagues steered the Federal Reserve onto a new tactical course, designed to strengthen the economy by extinguishing inflation. By early 1980 a decisive turn came. At first, the dollar strengthened because the balance of payments had improved, but then came the mutation. By the end of 1980 the overwhelming influence on the dollar was no longer the country's balance of payments and price behavior, but instead its exchange value was being determined by the inflow of foreign funds from everywhere into the dollar. From that time until today, whether recorded as flows across the frontier into this country, or unrecorded as other currencies have flowed into the large mass of dollar-denominated securities available in offshore markets, there has been an incessant drain of funds from other countries into dollar assets.

The exchange rate of the dollar, as determined in the free markets for currencies, has for the past five years been set by persistent flows from other currencies into U.S. dollar-denominated physical assets, securities, and cash. There is no longer any presumption that exchange rates will be primarily influenced by balance of payments surpluses or deficits, or by the relation between the prices of goods and services available in the United States and those in other countries -- i.e., the old "purchasing power parity" which used to be a reference benchmark in determining the fixed exchange rate between another currency and the dollar. Instead, an irregular but continuing rise in the dollar against all other leading currencies has turned causality around. Our goods are "priced out" of other markets; foreign made goods are flooding into the United States. This country today, with the strongest currency since the early postwar years, is running the largest balance of payments deficit ever experienced by any leading country anywhere -- short of the distortions of allout war.

That is the mutation which now must govern our appraisal of what to expect from the dollar, and the balance of payments, as major elements affecting the economic component of American foreign policy and the performance of the global economy. For my part of this needed appraisal, I will try to answer three sets of questions:

(1) What are the causes of the capital inflow? How persistent may those causes be?

(2) What are the consequences of this new phenomenon? good or bad? shorter run and longer run?

(3) What, if anything, could be done to bring our capital-flow-determined exchange rate closer to the underlying ratios between the actual prices of our goods and services and those of other countries?

I. The causes and persistence of capital inflows.

There is an element of truth, but also of irony, in the view frequently repeated in this city that the dollar's strength is simply a mirror image of the anemic recovery of most other leading countries (always excepting

Japan). Indeed the capital inflow is in a way a sort of perpetuum mobile: inflows here represent drains from the savings of other countries; the initial upward impetus that such flows give the dollar is accompanied by some lessening of investment momentum in the country losing savings; the incentive for still further outflows from the other country into the dollar is thereby increased; and so on -- the dollar strengthens and other currencies weaken. But that is only one part of the picture. What accounts for the capital inflows in the first place? There are at least five interrelated reasons, all byproducts of the enormous growth in the international money and capital markets, and in the diversity of facilities to service those markets, over recent years.

First, there is the appeal of very high interest rates on dollar obligations, which have wide spreads above the interest rates of most other industrial countries (in both nominal and real terms). Although this has often been considered the primary influence on the decisions of foreigners to send funds into dollars, and although short term movements of the dollar frequently do seem to parallel fluctuations in U.S. interest rates, I doubt that any contrived effort to force down interest rates here could, of itself, shut off the inflow, or provoke a reverse outflow, sufficient to bring the dollar in the exchange markets back down into line with the purchasing power relations between our prices for goods and services and those of the rest of the world. Our high interest rates have had the effect at times, however, of impelling other countries to tighten money in order to raise their interest rates and thus lower the spread, meanwhile limiting their own domestic expansion.

Second, another part of the demand for dollars to hold arises simply from the dollar's ready usability as an international transactions currency, as emphasized and illustrated by the conventional pricing and payment for oil. Despite efforts to encourage increased use of other leading currencies -- most notably the yen and the composite currency created by the European Monetary System, i.e., the ECU -- the proportionate use of the dollar has apparently been actually increasing over the past year or so. Its convenience for use in international transactions has developed a self-perpetuating momentum as the cash balances needed to support those transactions have grown.

Third, quite apart from any invidious comparisons with the economic performance of other countries, there is a natural flow of funds from abroad into a prospering economy which is demonstrating the alluring prospects of flourishing private enterprise for profitability and growth. How long that allure will remain important may depend on how well and how long this country fends off the recession that I and many others consider inevitable unless the domestic government deficit is brought down steadily, and soon.

Fourth, in addition to the profitability of investments in the United States, the attraction of dollar assets as a "safe haven" also has drawing power. The dollar serves as a refuge for flight capital from weakening economies, or from countries with unstable governments, or from countries fearing threats to their national security. The continuity of stable government here as a comforting assurance of security might, of course, be at least partially offset if the United States were to lead the world in experiencing a serious economic recession.

Fifth, one further overlaying influence adding to the strength of the dollar is the lure of speculation. To be sure, that may include the fickle support of hot money, with the attendant risk of sudden reversal, but thus far the repeated strength of the dollar has clearly accounted for some of its own further strengthening as it fostered expectations of market appreciation. Indeed, much of the trading in currencies is purely transitory, as indicated for example, by the high volume of transactions on the Chicago Mercantile Exchange which are purely paper deals, settled by payment of realized spreads without any actual movement of foreign exchange.

It is as the combined result of these five factors, along with the somewhat mottled developments affecting other industrial countries and their currencies, that the dollar exchange rates for the D-mark, sterling, French franc, Italian lire, various Scandinavian currencies, and several other OECD currencies (excepting the yen) have by early 1985 dropped to less than half their 1979 value in terms of dollars. Even when a reversal occurs -- and that seems inevitable eventually because of the present top-heavy relationship of market exchange rates to the underlying ratios between actual prices for goods in the U.S. and those outside -- the nature of these five causal factors suggests that there need not be a full decline of the dollar back to purchasing power ratios.

Let me just briefly explain why I think so. As to interest rate spreads, so long as the savings rate remains low in the United States, and borrowing demands from Government and the private sector here tend to exceed the available pool of domestic funds, U.S. interest rates will probably exceed those of other industrialized countries much of the time -- barring a deep recession. As to the transactions use of dollars, any significant shift to other currencies for use in international transactions may be a long time in coming, unless the usefulness of other currencies should be spurred by the proliferation of protectionism here, as our imports surge under the stimulus of a dollar kept strong by capital inflows. The vigor and profitability of the American free enterprise system also will surely look attractive to foreign investors for a long time to come; and that attraction will be reinforced by the evident stability of our political process. Finally, as to speculation, it will as always be a fair weather friend, and if a turn comes, frightened speculators may lead a run out of dollars. But that could, in ways that I will describe later on, be checked if the descent of the dollar threatened widespread chaos.

My conclusion, then, after reviewing the array of causes for the flow of capital into dollars, is that they are likely to continue for several years to produce an overvalued dollar, though probably at a level appreciably lower than the dollar's present stratospheric height in the exchange markets above the prices of the goods we buy abroad. In the current jargon, this means that I expect a "soft landing" when the dollar begins to decline. All bets are off, of course, if budgetary profligacy here produces a whopping recession; government borrowing balloons further; interest rates soar; stagflation returns; capital flows out; the dollar plummets; and in suffering a "hard landing," we lose the proud position of leadership on the world stage that has been buttressed by our strong economy and our strong dollar.

II. The consequences when exchange rates are determined by capital flows.

As I have already stressed, when exchange rates are largely determined by capital flows, rather than by balance of payments and price performance, quite a new set of influences is unleashed on the world of international trade. It is no longer possible simply to take for granted the norms of the GATT framework — i.e., that the removal of trade barriers will make possible the most productive and efficient use of resources in every country, and the resulting exchange of goods will promote the highest possible living standards which any country could sustain. The original GATT, together with the IMF, presumed a world working toward that idealized objective with the help of exchange rates that were determined over time by the purchasing power ratios between the prices prevailing in a given country and those of all other countries in its trading orbit. But with capital flows of all kinds now exceeding the transactions payments for goods and services by multiples of anywhere from ten to fifty on given days, or for considerable periods, the actual exchange rate is dominated by those flows. Yet it is still the case, in my view, that exchange rates closer to purchasing power parity would over time promote more trade, a more stable balance in the distribution of productive capital among countries, and more effective use of the world's human and material resources.

At this point, I propose just briefly to identify the kinds of distortion from such a norm or goal that are introduced by a capital-flow-determined exchange rate. Not all of the effects of that kind of exchange rate have been bad, indeed quite the contrary, in the shorter run many have been quite useful. The risk lies in the sequence of reactions which these temporarily useful results may set off. In a concluding section of these remarks I will take a look at what can be done to limit any unwelcome persisting distortions. For now, I will simply enumerate the most pronounced effects of the wide spread between the high actual exchange rate for the dollar and the basic or fundamental range of exchange rates that would reflect purchasing power parity with other leading countries.

The direct effects of the gap between actual and basic rates for the dollar have been a substantial expanding of our imports and a marked slowing down in the growth of our exports. Our trade deficit has consequently mushroomed. Old conceptions of causality have been reversed. Instead of large deficits causing a weak exchange rate, a strong exchange rate resulting from capital inflows has produced a weak balance of payments. Seen from the United States, there have been two currently useful effects, and two quite forbidding results of these developments.

On the plus side, clearly the effect of an inpouring of foreign goods (at prices which become extremely low when translated at the actual exchange rate) has been to reinforce the effects of the Federal Reserve's success in bringing down inflation. There has been a second, correlative effect. Less costly goods arriving from abroad have had a salutary competitive impact on American business managements -- stimulating cost discipline, improved efficiency, and greater innovation -- both in the attempt to hold onto markets at home and to retain markets abroad. Meanwhile, there has been a strong incentive to import foreign technology and to acquire businesses abroad at markdown prices.

On the negative side, with somewhat longer term consequences, two other very conspicuous developments have occurred: an increasingly intense urge for protectionism and a remarkable rise in the debt owed to foreigners. Even though the Administration has consistently supported the principles of open markets and freedom of trade, pressures from some firms and industries have become irresistible. The decision last week to give up quotas on the import of Japanese cars may, however, portend a pattern of limiting such protectionist restraints to the periods needed for transitional adjustment in the United States. On such terms, the corrosive longer term effects of protectionism on the efficiency and survivability of American firms might be minimized.

Growing foreign debt is the counterpart of the capital inflow that pushed up the dollar: the future interest and dividend burden of that debt will largely offset the surplus in the services account that formerly helped to keep the dollar stong. The growth of the debt itself has also clearly lowered the threshold of U.S. vulnerability to future reversals in foreign sentiment — increasing the risks of a future "run" from the dollar.

Just as there has been both good news and bad news for the United States as a result of the strong dollar, there have also been mixed results for other countries, but on balance their losses may have exceeded their gains. The gain clearly has come from the expanding of exports to the United States, with the possibility that such sales will become a foothold for future growth in U.S. markets. Meanwhile, the macroeconomic effect has been that of pump-priming the economies of several of our allies. And American tourists have been overrunning much of the world, providing useful stimulus to service industries abroad.

The adverse side for other countries has been felt in (1) the rising cost of dollar-denominated imports; (2) the outward drain of savings and upward pressures on interest rates in the effort to keep some savings at home, but with dampening effect on the home economy; and (3) for the developing countries a heavy added burden for service on their large outstanding debts (which may outweigh any improvement in their sales to the U.S.).

Along with the most direct distortions, the same forces that cause a persistently overvalued dollar also provoke very wide and frequent swings in the exchange rates of all currencies against each other. The result of this excessive volatility has been to encourage the development of ways to bypass the currency system altogether through resort to barter, or in more sophisticated form, to countertrade. As all currency exchange rates come to be more and more determined by volatile capital flows, while also reflecting some degree of persisting dollar overvaluation, the temptation of firms and of nations will be to turn increasingly to direct bilateral exchanges, or trade agreements, in which effective price ratios can be determined by the prices at which each other's goods will sell in their own marketplace, without regard to any translation of values through actual exchange rates. The paradoxical consequence of such scattered attempts to approximate purchasing power exchange ratios between goods (and to avoid the buffets of oscillating exchange rates) will be a fragmentation of trade, rather than the multilateralization which can best optimize the trading opportunities of a complex world economy.

The uneasiness that bothers me, in trying coldly to assess the pros and cons of what an "overvalued" dollar does, is the haunting question: how long can all this possibly last? The prospect of an insistently rising dollar, of ever higher trade deficits, and of continuing increases in foreign borrowing abroad to help finance an ugly deficit in our own Government accounts, strikes me as an unstable combination -- something may have to give, perhaps explosively, unless a start can be made toward bringing the actual dollar exchange rate closer to the purchasing power relationship of our goods and services to those of the rest of the world. So I turn now, in the concluding section of these remarks, to the third question I asked at the beginning: what could or should be done?

III. Can the gap between our capital-determined exchange rates and basic price ratios be narrowed?

It is fruitless to expect that the problems I have described will just naturally fade away. The galaxy of international facilities and resources now committed to the international financial markets are surely here to stay. Any attempt directly to manage them through exchange controls would be fruitless; and the bureaucratic byproducts, unacceptable. Moreover, for many of the reasons already mentioned, the dollar is likely to retain at least a modest premium most of the time for some years to come. Yet the distorting consequences of the hugely overvalued dollar are too great to permit the luxury of just waiting for a narrowing of the gap between actual and basic exchange rates to happen. Indeed laissez faire might well eventually mean narrowing the gap through a breakout of inflation around the world outside the United States. It might also mean pushing our borrowing from foreigners beyond the margin of tolerance, causing higher interest rates and sharp recession here as capital inflows subside or outflows begin. Such events would only introduce more disorder into the world. What instead could be done?

It is probably too much to hope for correction on the side of price relationships. Our price inflation has come down about as far as practicable; correction abroad, to bring price ratios in line with today's actual exchange rates, would imply price rises in many other countries of more than 50 percent -- hardly a credible proposal. So attention will have to focus on ways in which the net outflows of capital into dollars could -- short of any misguided attempt to control them directly -- be reduced through several indirect kinds of influence. One might be through narrowing the spread of our interest rates over the interest rates of other industrialized countries. Another might be through stimulating a reverse flow of capital out of this country to offset the flows coming into dollars. A third could be central bank action to intervene in the currency markets at propitious times both to limit volatility and to chasten the speculators, lessening their readiness to accelerate upward dollar moves. Any of these would imply a meeting of minds, and agreement on procedures, among the financial officials of the leading countries. That leads me, in advance of any further elaboration of the three paths of possibility, to describe briefly a concept of collaboration among leading countries that I have been advancing, in various forms, for the past ten years or more.

Originally, I called this concept one of seeking "target zones" for key currency exchange rates. This would involve regular and frequent consultation among responsible government officials of several countries for the purpose of agreeing on appropriate "target zones" for their exchange rates. That would be followed by their conferring on the compatible procedures they might urge their governments to follow in edging exchange rates toward those targets. However, age has mellowed my earlier formulation. I now hope to get attention, sometime, for a similar approach aimed at a more modest objective -- agreement on limited "directional aims" for exchange rates rather than the more ambitious setting of "target zones."

The starting point would be for any group of three, or five, or seven, or even more of the leading countries to agree on their their common interest in focusing joint attention on the directions in which market rates of exchange might best move. They could then work with each other to consider ways of getting such movement in motion. In doing that, they would establish a framework for pursuing the three paths of possible action to which I alluded a minute ago.

Narrowing interest rate spreads.

If other participating officials were to agree with our representatives that the dollar should begin moving downward against their currencies, they might then agree that actions to reduce interest rate spreads would help to lessen capital flows into the dollar. To the extent consistent with other aspects of domestic policy in each country, the other participants might then undertake within their own governments, subject to whatever procedures would fit their own financial structure, to try to reach agreement on action to nudge their interest rates upward. For some, that might entail a tightening move in monetary policy, or a more expansive fiscal policy (with increased domestic borrowing needs), or perhaps both.

For the United States, a converse course might be indicated, that is, reducing the Government's budget deficit and borrowing requirement, along possibly with a touch toward ease in monetary policy. The prescription would begin to fulfill the aphorisms on harmonizing fiscal and monetary policies that have come from the past two Heads of State Summits of the seven leading industrial countries. Perhaps attention could, in these circumstances, also be directed toward synchronizing the impacts of the tax policies of each country on capital flows. The difference in what I am suggesting would be that aims would be more explicitly identified, and actual courses of action (and their limitations) fully aired, within the confidential confines of a negotiating framework limited explicitly to these explicit areas of deliberation.

With respect to the U.S. Government deficit, the possibility exists of a reverse twist. That is, substantial reduction of the deficit might so impress foreigners with the evidence of fiscal responsibility and firm Government control that new flows into the dollar might result -- even if the interest rate spread had been narrowed. But such a state of affairs would also make any rise of interest rates by the other countries unnecessary. They could feel free to pursue more expansionary policies. The longer term result might be the even more desirable one that their imports from the United States would increase, and their own economies might absorb more of the goods previously destined for the U.S. In effect, balance of payments forces could then begin reasserting some influence on exchange rates, despite any continuing capital flows into dollars.

Stimulating reverse flows of capital movements.

Perhaps, along with an agreed aim as to interest rates, or as an alternative, the same designated group of country officials could consider the scope for stimulating a reverse flow of capital movements, for the purpose of offsetting to some extent the impact of capital inflows as an upward influence on the dollar. The United States Treasury through its Stabilization Fund, or the Federal Reserve, could be encouraged to begin acquiring holdings of foreign currencies. The host countries might undertake to assist the placing of such holdings in interest bearing securities -- either through purchases in the market or through new Government issues, whichever best suited the domestic money and securities markets. The dollars used by the Treasury for its purchases should be accumulated so as to avoid further strain on our own markets. Such transactions need have no budgetary implication because the borrowing would be matched by marketable assets. If the Federal Reserve were to make purchases through direct credits on its own books, it too would be acquiring corresponding assets, but it would have to guard against any creation of new credit in excess of the going needs of monetary policy. That it could do either by making foreign currency purchases sparingly, or by sterilizing the new credits through open market operations.

To be sure, if the eventual outcome were to be a rise in the value of the foreign currencies against the dollar, the U.S. would in time earn a capital gain, as well as deriving a higher dollar equivalent for its interest receipts. The negotiating agreements might provide that any such gain could be shared with the host govenment (a practice for which precedent was established when Secretary Dillon and I pioneered with a forerunner of such procedures early in the '60s).

As a further offset to market flows of capital into dollars, other governments might simply meet some of their own deficit needs by borrowing in dollars, either in New York or in the overseas markets for dollars, and then converting the dollars into their own currency, thereby helping to strengthen that currency against the dollar. Care would be needed to assure that the borrowings were gauged to the availabilities of dollars in the market at the time. But the fact that such operations would be conducted as a joint enterprise, conceived in consultations among the foreign goverments and our own, would assure the smooth calibrating of any incidental impact on the domestic dollar market. Gains or losses from subsequent currency appreciation or depreciation should similarly be divided equally between the foreign government entities and the participating arm of the U.S. Government.

Although no formalized approach has yet been even considered at the governmental level for the negotiating of such capital flows as offsets to the heavy inflow of capital into dollars, it is significant indeed that the Japanese have on their own initiative issued their first Nakasone bond for that purpose last spring, on a very limited, exploratory basis. The dollar proceeds were all converted through the market into yen. It was most gratifying to find, during a visit with Prime Minister Nakasone last November, that he is personally quite interested in the possible further development of this approach, as one means for lessening the undervaluation of the yen in relation to the dollar.

Perhaps, if intentions of this kind were announced by the various participating countries, some parallel action could begin in the private sector. It has been surprising, with respect to purchases of foreign assets by Americans, that so little direct investment has occurred at a time when the dollar cost of facilities anywhere in Europe, for example, is less than half of what it would have been five years ago. Conversely, though not as surprisingly because of the high dollar interest rates, there has been very little borrowing by private sector Europeans, or Japanese, or others in the United States for the purpose of repatriating dollars into their own currencies for use at home. Quite the contrary, foreign investors have simply sent their own funds into dollar investments, thereby causing the high dollar exchange rate.

However, borrowing in dollars, even though expensive, and even though large magnitudes of borrowing might tend to push up our interest rates, would seem to be an interesting hedge against that eventual time when the dollar does begin to decline. A lead shown by Governments in undertaking to borrow dollars and then to convert the dollars into the home currency, might be just the signal needed to evoke some corresponding response from the private sector. To be sure, the magnitudes of government action -- either U.S. purchases of foreign currency assets, or foreign borrowing of dollars -- would appear small in magnitude alongside the huge volume of short term transactions among money brokers that occur every day. But the visible evidence of determined official action to offset the market's upward pushing of dollars might well have a significant, favorable impact. A more fertile opportunity would be created for the use of central bank intervention directly in the trading markets.

Central bank intervention

The record of central bank intervention since it was introduced during my Treasury tenure early in the '60s has been a rather spotty one. We originally conceived of central bank intervention in the currency markets as a means of keeping market exchange rates within an agreed band around the established parities and of minimizing volatility. Intervention was ordinarily undertaken only for orderly market purposes or to check what appeared to be speculative forays. The result usually was to dampen oscillations or to quell a speculative ferver and lead to a natural market return toward par, or even beyond. Pursued in this way, intervention had modest objectives and it almost invariably proved profitable to the central banks undertaking it.

Very early on, because the utility of such techniques quickly gained widespread acceptance and approval, we initiated the so-called "ring of "swap. This procedure involved agreement between the United States and other countries individually, through which each could borrow the other's currency up to a specified limit, simultaneously making a deposit of its own currency with the lending central bank. Thus, the term "swaps." It was presumed that no swap would remain outstanding beyond one year, owing to the temporary nature of the aberration which their use was designed to check. However, if the initial judgment proved in error, and it appeared that the swap would have to remain outstanding for more than a year before any natural market reversal would occur, a further technique was introduced. The swap obligation could be converted to a bond. That is the way in which the so-called Roosa bonds came into being.

It is this same complex of swap arrangements that has persisted through the years of floating exchange rates following 1973. Today the Federal Reserve (and in some instances the Treasury's Stabilization Fund) has swap lines with some fourteen central banks as well as with the Bank for International Settlements. As these now stand, they could be mobilized either on the initiative of any of the other fourteen countries, or of the United States, to reinforce other programs aimed at checking disorderly conditions in the foreign currency markets or curbing speculative excesses. So far as can be known publicly, the substantial intervention by other central banks, using dollars to buy their own currencies during recent months, has been financed out of the existing reserves of these central banks. It should nonetheless be clear that the existence of the swap facilities gives assurance that substantial reserves remain to be drawn upon, in addition to reserves actually owned, if there were to be a concerted approach to intervention by major central banks during these days of a continually overvalued dollar.

Intervention cannot be viewed as a sledgehammer for driving markets in a direction contrary to strong underlying forces that are currently affecting capital flows. However, in thin markets, intervention may help provide a sense of direction to the markets. The appropriate role for intervention in most circumstances is analgous to the rapier or the scalpel, used to pierce or cut away speculative fluff. Often indeed its purpose is served simply by testing the strength of a move which may or may not be generated by underlying forces. If the direction of change persists despite the testing, the authorities will recognize the apropriateness of accommodating the change rather than combatting it.

The purposeful role of intervention can only adequately be served if there is agreement on both sides, not only as to the desirability of action but also as to the nature of the action to be taken. There have been no publicly noted instances of concerted intervention involving the United States on any substantial scale during these recent years of unusual dollar strength. If the institutionalized grouping of key countries should materialize along the lines I have outlined, the potential for meaningful intervention would be greatly increased.

It is quite possible, if there were a meeting of minds and of procedures, that intervention could serve three very significant purposes in the floating rate environment. To be sure, it could never be powerful enough to "make" a rate against the impetus of fundamental underlying capital flows or basic balance of payments divergences. But it could effectively guard against speculative surges based on expectations of the course which official policies might pusue. The three clear cases of useful intervention would then consist in: (1) checking a volatility that was becoming extreme and unstabilizing for the market; (2) counteracting conditions of speculative exhilaration comparable to those of February 25, 1985; and (3) resisting conditions of speculative fright in the event the dollar (or any other currency) began a sudden downturn which threatened to become a nosedive. To be sure, implementing these potentials depends both upon agreement among the responsible officials and skill in market execution. There is no necessary reason to believe that these conditions could not, if supported by a strong operational commitment, be fulfilled. That kind of commitment would put into action the noble expression of intent at the recent 7-country Summits.

. . . .

Mr. Chairman, this rather lengthy summary should, I would hope, leave three propositions in the minds of the Committee: (1) the wide gap between exchange rates determined by capital flows and the price ratios among countries has created for a time a unique stimulation to the world economy as the United States became pump-primer for the world; (2) the longer term stability of the global economy, and of its growth, will require action aimed at narrowing this gap over the months and years ahead; (3) as the gap narrows the disruptive protectionism and fragmentation of trade that has threatened to impair the future flourishing of a multilateral trading system will diminish and the way will open for a return toward that favorite concept of the classical economists: an optimum division of labor among all nations and an optimum realization of the economic potential lying within each of them.

The **Chairman.** Thank you very much, Mr. Roosa.

Would you give your testimony, please, Mr. Trowbridge?

STATEMENT OF ALEXANDER B. TROWBRIDGE, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. **Trowbridge.** Thank you, Mr. Chairman.

I share the opinion of my colleagues here that there is no more important subject today than the relationship between the U.S. economy and the global economy, commend this committee for calling these hearings, and appreciate the chance to state NAM's views.

The stresses now evident in the international trading system and the international financial system have serious implications for the viability of many American businesses and for the character of the U.S. industrial base. If that means that there is a crisis of competitiveness, and we believe it does, then it means there is a need for actions and policies which we as a country need to implement.

That point has been made effectively recently by two Presidential study groups, the President's Commission on Industrial Competitiveness, chaired by John Young of Hewlett-Packard, and the President's Task Force on International Private Enterprise, chaired by Dwayne Andreas, who is here with us today.

The work of both commissions deserves a positive response from all who are concerned with the U.S. stake in the global market. For U.S. industry, America's stake in the world economy is not an abstract notion. For most of America's major corporations, it is the daily reality of buying and selling and producing abroad, of increasing coproduction arrangements with offshore establishments.

The concept of coproduction can be seen across the spectrum of manufacturing, from shirts to semiconductors, from automobiles to jumbo jets. The numbers are impressive. The United States is the world's largest exporter. Our agricultural and manufacturing sectors made shipments to foreigners valued in 1984 at about $218 billion.

The United States is the world's largest importer. Our 1984 import bill was $341 billion, or almost one-fifth of the world's exports. A level of imports that is half again as high as our exports is unhealthy for our economy and ultimately unsustainable.

There has been a dramatic increase over the last decade or so in the use of coproduction and sourcing arrangements between American manufacturers and their associates abroad. Now, our members have a very practical appreciation not only of the business opportunities associated with an open trading system, but of the importance of that system to our country's foreign policy interests and indeed to our security.

We understand that economic progress abroad is progress toward a safer and more secure world. Even so, it would be a mistake to overlook our first concern, which is the economic strength of the United States. That is, after all, what makes possible the achievement of our goals as individuals and as a society, and drives the economies of many other nations.

U.S. manufacturing is the bedrock of that strength. Visible trade is largely a matter of manufactured goods. Some 66 percent of all U.S. exports are manufactures, and 68 percent of our imports.

In short, a strong America without a strong manufacturing sector in our view is inconceivable. From this perspective, the recent trends in U.S. trade are worrying. Trade today is no longer an American success, but the worm in the apple of U.S. prosperity.

In 1984, the merchandise trade deficit of over $123 billion is a clear indication that something is seriously wrong, not just in its magnitude, but also in its character. Seventy-two percent of that deficit, $89 billion, is in manufactured goods.

As recently as 1981, the United States had a surplus in manufactures trade of over $5 billion. The erosion of U.S. competitiveness can be seen in virtually every sector. In January, before the 1984 figures were put out, we prepared a table showing major sectoral balances in manufactures trade. This is reproduced in my prepared testimony.[1]

As you can see, the United States has lost ground in all major sectors in the period between 1980 and 1984. I will also supply a chart showing the trade balances for the major trading partners or countries, and the same erosion is seen.

---

[1] See page 341.

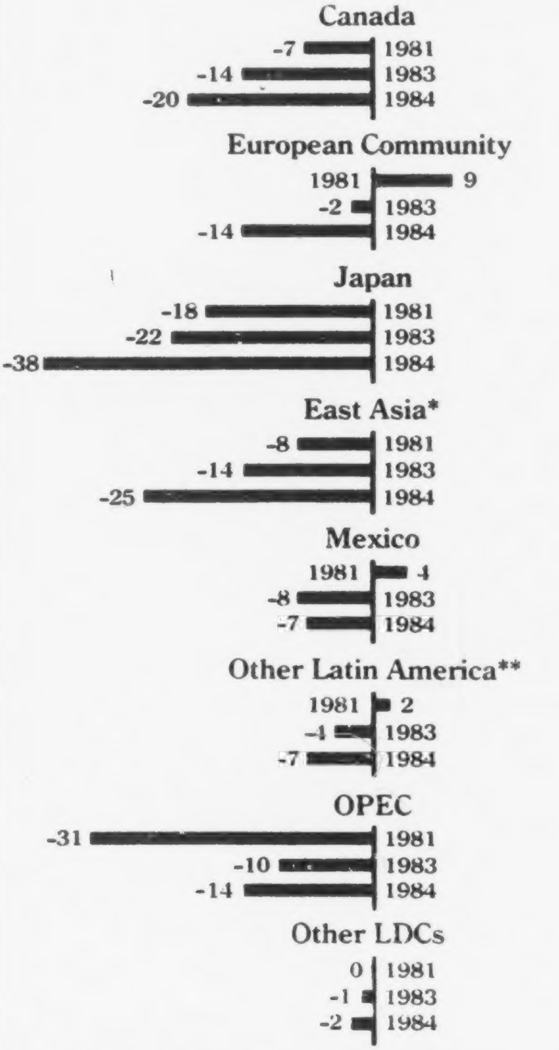
from NAM's Trade & Industry, January 18, 1985

Figure 3

U.S. Trade Balances With Major Trading Partners

(Jan.-Oct. 1984, Annual Rate)

All Figures in $U.S. Billions-Imports c.i.f.



*Excluding Indonesia, which is counted with OPEC.
**Excluding Venezuela and Ecuador, which are counted with OPEC.
Source: NAM, from Commerce Department statistics

We think it is really fatuous to say that we should not look at this or that bilateral deficit on the grounds that it is offset somewhere else in the system. The truth is that we are in deficit with virtually all of our major trading partners. Many people, including many of our own members, are now giving serious consideration to ideas which in the past would have been rejected out of hand.

The growing level of frustration is visible both in the business community and in Congress by the long list of trade proposals which are protectionist in nature. In our view, exchange rate misalignments are the principal cause of our difficulty, and there is little chance of American industry becoming truly competitive if nothing is done on this front.

I referred earlier to the two commissions, the Commission on Industrial Competitiveness and on International Private Enterprise. The recently released reports of these groups should be required reading for every concerned citizen. "We should agree that America must take the challenge of competitiveness as the economic agenda for the next decade." That is a quote from those reports.

Second, we should share the commissions' views with respect to the four major recommendations of the report, namely, that we need to do better in creating, applying, and protecting American technology. We need to reduce the cost of capital for U.S. industry. We need to develop a more skilled, flexible, and motivated work force. And we need to make trade a national priority.

I would like to concentrate this morning on the last of these recommendations, trade as a national priority. Dwayne Andreas' commission said that there is a need to elevate international economic policy to a level comparable with national security. We agree with that.

We agree with John Young's comment in his letter of transmittal to the President: "The competitiveness challenge calls for the leadership only you can provide." Above all, we need a commitment to competitiveness articulated by the President, given substance by the executive agencies and the Congress, and understood as part of our national purpose by the American people.

The first expression of this commitment, I think, could be the creation of a Department of International Trade and Industry. It would help the Government confront the major tasks that Government must confront if the United States is to respond successfully to the challenges of trade and competitiveness.

The Young Commission has pointed out that most of the job of being more competitive falls to the private sector. That is certainly true. But we need to avoid thinking in terms of a false dichotomy. America does not compete in the world as a bureaucracy or a collection of firms. We compete as a society.

We recently had a briefing from the chairman of one of our member companies, a company which in his words was a medium-sized, medium-technology firm. They are feeling a lot of pressure from imports from the Pacific rim countries whose products are selling in the United States at prices that are 35 to 40 percent of the U.S. company's prices. In fact, about 60 percent of this NAM member company's products compete with low-cost foreign imports. The company has a policy to deal with the problem.

"Our policy," the chairman said, is to "stand and fight." He has taken a lot of steps. It is worth listing a few of them. The firm discovered that there are no less than 14 different companies in Taiwan and Korea imitating its products. It has begun a determined effort to prosecute those who violate its trademarks and other rights.

The firm has dramatically reduced its inventories and improved its cash management. They have reduced operating expenses generally, including a 24-percent reduction in employment since 1980. They have realigned their pricing so that extra services in support of their products are charged separately in that imported products do not provide those services as part of their lower prices. They have cut out whole layers of management, and they have improved productivity by new investments.

As an appendix to my testimony, I have attached a reprint from the March 3, 1985, New York Times which cites five other examples of companies trying to be competitive with the "muscular dollar." These actions have kept them in the ball game, but without an improvement in the exchange rate picture, they will probably have to begin more and more sourcing and production overseas.

The burden of the highly valued dollar hits farmer and manufacturer together. Our Government in recent months has begun to take steps toward bringing the dollar in line with the other major currencies, but it must make it clear that we will do what needs to be done to achieve that result.

At the least this would include a serious deficit reduction package in the fiscal year 1986 to 1988 budget path, an expressed willingness to intervene in foreign exchange markets which have become "disorderly," and where intervention can be "helpful," to use the Treasury's criteria, and greater cooperation with the central banks of the other key currency countries.

I would like to add for the record a resolution by the NAM board of directors on the exchange rate passed on February 10, 1985.

[The material referred to follows:]

NAM

ADOPTED BY NAM BOARD OF DIRECTORS
FEBRUARY 10, 1984

RESOLUTION ON THE EXCHANGE RATE FOR THE U.S. DOLLAR

Whereas a competitive U.S. industrial base is possible only if the exchange rate for the dollar is realistic relative to the currencies of other major trading countries;

Whereas exchange rate policy must be developed within the context of national economic policy, and macroeconomic policies must be shaped with due regard for direct and indirect impact on exchange rates and trade;

Whereas the substantial rise in the value of the dollar against the yen, the deutsche mark and other major industrial country currencies in recent years has more than offset the reduction in the U.S. inflation rate and efforts to improve industrial productivity, thus making American-produced goods less competitive in both domestic and world markets;

Whereas the reduction in U.S. price and cost competitiveness due to exchange rate changes alone has been calculated as costing more than one million jobs in the domestic U.S. economy and has contributed significantly to the 1983 record U.S. trade deficit of $70 billion;

Whereas the effects of the dollar exchange rate misalignment are most serious respecting the yen and the deutsche mark, the currencies of our principal industrial competitors, and have contributed to their very large manufactured goods trade surpluses, as well as to the huge and growing U.S. trade deficit;

Whereas the deterioration of the U.S. trade and current account balances since 1980 has not led to a counter-balancing reduction in the exchange value of the dollar, but rather the dollar has maintained its value or even strengthened significantly against all major foreign currencies;

THEREFORE BE IT RESOLVED that the National Association of Manufacturers recommends that the U.S. develop fiscal and monetary policies designed to achieve progressive elimination of the federal budget deficit and reduction of high U.S. interest rates, and thereby help the dollar reach and maintain an exchange rate appropriate to the U.S. competitive position, while achieving major domestic macroeconomic goals.

BE IT FURTHER RESOLVED that the National Association of Manufacturers urges the development of an explicit U.S. exchange rate policy supportive of U.S. trade performance. Such an exchange rate policy should include:

- Improved coordination and consultation with other countries regarding the international effects of domestic economic policy, with the purpose of reducing dollar exchange rate misalignment, in accordance with agreements reached at the 1983 Williamsburg economic summit;

- Improvement of the present exchange rate system through the introduction of a greater degree of structure, the purpose being to reduce the present dollar misalignment without excessive levels of government intervention in currency markets;

- Special attention to the international position of the Japanese yen, to encourage its greater use as an international transaction and reserve currency, and thereby to encourage greater international demand for the yen relative to the dollar — thus raising its value. The recent agreement of President Reagan and Prime Minister Nakasone is an important step in the right direction and should be fully implemented as soon as possible.

In addition, the U.S. should take the lead in seeking long-term improvement in the international exchange rate system. Consultations with Germany, Japan, other major industrial countries and the IMF to reform the present system should be undertaken, so that it can better achieve the original objective of facilitating trade and investment by reflecting changes in economic fundamentals which determine competitiveness.

Mr. **Trowbridge**. I would like to offer some of the other measures that the U.S. Government can take to improve American competitiveness.

On export barriers, there are several export barriers in the U.S. law, and we have lived through and never fully recovered from the immense damage caused by our unilateral grain embargo and our sanctions imposed on the trans-European gas pipeline, but we still suffer from the doubts in our reliability as exporters who can fulfill contracts, especially given our approach to export controls.

The President's Commission on Industrial Competitiveness has put this problem in perspective. Today foreign policy controls are estimated to cost the U.S. economy $4.7 billion annually in lost exports, and national security controls are estimated to cost us another $7.6 billion in lost sales. That is $12.3 billion in lost sales, or one-tenth of the U.S. trade deficit.

It is our hope that a new Export Administration Act, one that more clearly recognizes the importance of exports to U.S. economy and U.S. security, will result in fewer controls and more sales. We urge prompt Senate action on the bill, H.R. 28, now going through the various subcommittees and will go through the full House Foreign Affairs Committee, we hope, this session.

Improving the international trade system. The call for a new round of multilateral negotiations expressed by the President in the State of the Union Message was welcome. The realities of trade have outstripped the basic international law of trade, the General Agreement on Tariffs and Trade, which has begun to fall into serious disrepute, largely because business people and officials have lost faith in the GATT's ability to provide meaningful discipline over the large variety of trade-distorting practices that proliferate in the modern commercial world.

In the coming months, we should be working with our members to develop a better statement of NAM's objectives for a new round, but at the least these would include: greater discipline over distortive industrial policies; a better dispute settlement mechanism; a safeguards code that recognizes that industry-to-industry agreements that restrict trade are just as disruptive as government-to-government agreements; a new hard look at the Government Procurement Code; real discipline in the counterfeiting area; and a meaningful set of rules governing trade and services.

Access to foreign markets. At the moment, our assumption is that the greatest potential and the most serious barriers are in Japan. We are not in a position to second-guess the administration in its current negotiations with Japanese officials on the access that U.S. firms have or should have in certain Japanese markets, especially electronics, telecommunications equipment, wood and paper, and pharmaceuticals.

The administration has worked hard on this, and they have let the Japanese know that there is a problem and that we expect them to solve it. I am not terribly optimistic that we will see anything like a $10 billion improvement in United States access to Japanese markets, but given the level of United States business frustration with Japanese trade practices, if there is no significant improvment, there is going to be a reaction.

We must convince the Japanese of our determination to see a more even distribution of the benefits of trade, including employment benefits as well as choices for consumers.

Determination to be competitive. As I said earlier, what our country needs is a very strong commitment to be competitive, and unfortunately, there are several key areas where we are sending exactly the opposite signal, such as export finance.

Roughly 10 percent of American manufactured exports benefit from official export credits. The comparable figure for Britain is roughly 55 percent, 35 percent for France, and 40 percent for Japan.

The current budget proposals concerning the Eximbank would weaken their ability to provide even the help it now provides, and that is not the type of commitment needed.

Trade law. Here, too, the exchange rate has adverse effects on U.S. companies. Take the case of the foreign producer whose price at fair exchange rates is roughly equal to the U.S. price. That producer would probably need to dump the product here to undersell his U.S. competitor and so get a toehold in the U.S. market.

But that is not necessary today. The misalignment of the dollar and other currencies gives him the same advantages without forcing him to resort to dumping. So long as one's focus is restricted to countervailing and antidumping, the question of resolve does not really arise.

It does arise in connection with section 301 of the 1974 Trade Act, which deals with unfair trade practices by foreign governments, and which is wholly discretionary with the President. We have no specific action to recommend here, but it is our view that a section 301 fillip to the Japanese or another trading partner may be much healthier for the trading system as a whole than any further erosion in the American business community's confidence that U.S. trading interests will be protected.

Americans are problem-solvers, Mr. Chairman, and we at the NAM do not believe that the problems before us are insurmountable, but they are indeed very large, and very important, and they can be overcome only if squarely addressed.

Bob Hormats talked to you last week. I believe he referred in his testimony to the extreme good fortune of the United States in enjoying freedom and prosperity and power all at the same time. If we do not make a creditable commitment to competitiveness, those blessings will be in jeopardy.

Thank you, Mr. Chairman.

[Mr. Trowbridge's prepared statement follows:]

TESTIMONY OF

ALEXANDER B. TROWBRIDGE

PRESIDENT
NATIONAL ASSOCIATION OF MANUFACTURERS

ON

AMERICA'S ROLE IN THE GLOBAL ECONOMY

BEFORE THE

SENATE COMMITTEE ON FOREIGN RELATIONS

March 6, 1985

Mr. Chairman, Members of the Committee, I am Alexander B. Trowbridge, President of the National Association of Manufacturers, the nation's oldest national trade association, with membership of more than 13,000 companies, ranging from smallest to the largest companies in the United States. Together they account for approximately 85 percent of U.S. industrial output and more than 80 percent of U.S. industrial employment.

There is no more important subject today than the relationship between the U.S. economy and the global economy. I commend the Committee for calling these hearings and appreciate very much the opportunity you have given me to state NAM's views.

In emphasizing the importance of the relationship between the U.S. and the global economy, I am not simply stating a corollary of bigness, important though that is. The stresses now evident in the international trading system and the international financial system have serious implications for the viability of many American businesses and for the character of the U.S. industrial base. If that means there is a crises of competitiveness, and we believe it does, then it means there is a need for actions/policies which we as a country need to implement. That point has been effectively made recently by two Presidential study groups: The President's Commission on Industrial Competitiveness, chaired by John Young of Hewlett Packard, and the President's Task Force on International Private Enterprise chaired by Dwayne Andreas of Archer Daniels Midland Company.

The work of both commissions deserves a positive response from all who are concerned with the U.S. stake in the global markets. For U.S. industry, America's stake in the world economy is not an abstract notion. For most of America's major corporations it is the daily reality of buying, selling, and producing abroad, and of increasing co-production arrangements with off-shore establishments. The concept of co-production can be seen across the spectrum of manufacturing from shirts to semiconductors, from automobiles to jumbo jets.

The numbers are impressive:

- The United States is the world's largest exporter, largely because our agricultural and manufacturing sectors are both major exporters and last year (1984) made shipments to foreigners valued at about $218 billion.
- The United States is the world's largest importer. In 1984 our import bill was $341 billion, or almost one fifth of the world's exports. A level of imports that is half again as high as our exports is unhealthy for our economy and ultimately unsustainable. Here, however, I simply wish to underscore that trade with the United States is understandably regarded as an essential feature of a great many national economies around the world.

- There has been a dramatic increase over the last decade or so in the use of co-production arrangements between American manufacturers and their associates abroad. It would be impossible to document these changes with precision, but a consideration of what has been happening vis-a-vis those special provisions of U.S. law designed to facilitate co-production arrangements might serve as a useful proxy. The use of foreign trade zones for example, like the VW plant in New Stanton, Pennsylvania, has skyrocketed. Counting the general purpose foreign trade zone and the special subzones together, there were only 18 zones in 1973, and the value of imports processed through them then was $161 million. By 1983 there were 117 zones, including subzones. The 1983 import value figures are not ready yet, but the 1982 figures show imports of nearly $4 billion for these two kinds of zones. That is almost a 25-fold increase in nine years. The same kind of change can be seen in the use of Section 807 of the Tariff Schedules, which is even more closely associated with co-production. This provision permits U.S. producers to take advantage of low-wage foreign labor to assembly components without having to pay duty on anything more than the labor itself when the finished goods are returned to the United States.

In reciting these few statistics I also wish to demonstrate that it is not abstract principle but solid business experience that lies behind NAM's strong and consistent support for an open world trading system over the course of many years. Our members have a practical appreciation not only of the business opportunities associated with an open trading system but of the importance of that system to our country's foreign policy interests and indeed to our security. We understand that economic progress abroad is progress towards a safer, more secure world.

U.S. Economic Strength

Even so, it would be a mistake to overlook our first concern: the economic strength of the United States. That is, after all, what makes possible the achievement of our goals as individuals and as a society, and drives the economies of many other nations. U.S. manufacturing is the bedrock of that strength. It would be foolish to denigrate the importance of the large service sector to our economy. Yet I agree with Lester Thurow's recent comment: "If your manufacturing industries go down the drain, most of the services will go down with them." We should add that visible trade is largely a matter of manufactured goods. Some 66 percent of all U.S. exports are manufactures; 68 percent of our imports.

In short, a strong America without a strong manufacturing section, is in our view inconceivable. From this perspective the recent trends in U.S. trade are worrying. Trade today is no longer an American success but the worm in the apple of U.S. prosperity.

Indices of Distress

The 1984 merchandise trade deficit of over $123 billion is a clear indication that something is seriously wrong, not just in its magnitude but also in its character. Seventy-two percent of that deficit--$89 billion--is in manufactured goods. As recently as 1981 the United States had a surplus in manufactures trade of over $5 billion. These numbers can only be understood as a serious erosion of U.S. competitiveness. If it is true, as Secretary Baldrige said the other day, that 75 percent of all U.S. products compete against foreign goods, either here or abroad, the implications for the U.S. economy are alarming.

The erosion of U.S. competitiveness can be seen in virtually every sector. In January, before the 1984 figures were out, we prepared a table showing "Major Sectoral Balances in Manufactures Trade." This is reproduced on page 6 of my testimony. As you can see, the United States has lost ground in all major sectors in the period between 1980 and 1984.

We also see the erosion in the character of our trade with most of our trading partners. It is now fatuous to say we shouldn't look at this or that bilateral deficit on the grounds that it is offset somewhere else in the system. The truth is that we are in deficit with virtually all of our major trading partners.

Lastly, what may prove to be the most convincing index of the gravity of the problem is that so many people, including many of our members, are now giving serious consideration to ideas which in the past would have been rejected out of hand. The growing level of frustration is visible, both in the business community and in Congress, by the long list of trade proposals which are protectionist in nature.

Recommendations

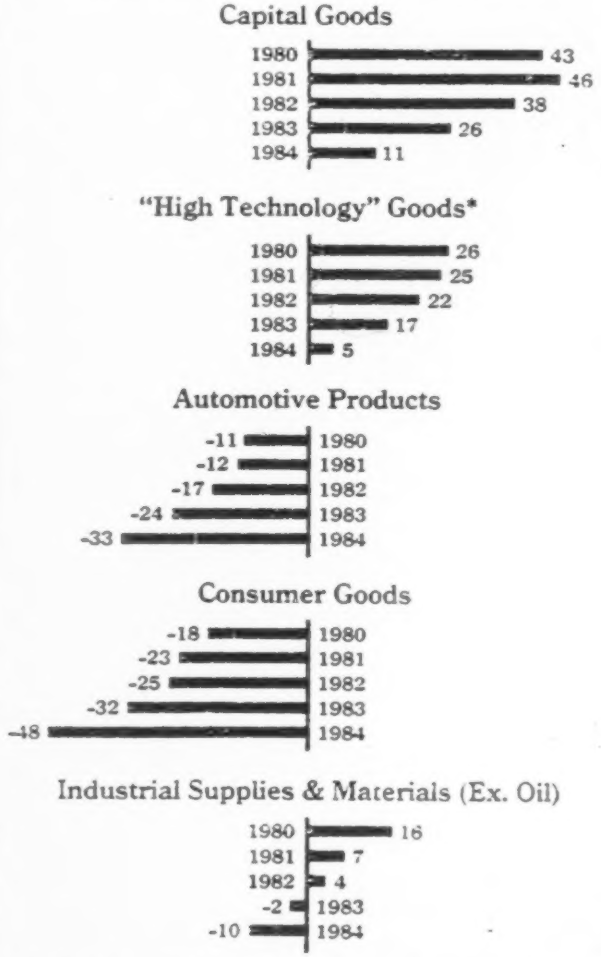
The President's Commission on Industrial Competitiveness printed two charts on the same page. One shows the dramatic rise in the value of the dollar since 1978 and the other the equally dramatic drop in our trade balance since 1980. These graphs are incorporated here. Exchange rate misalignments are the principal from NAM's Trade & Industry, January 18, 1985

Figure 1

Major Sectoral Balances in U.S. Manufactures Trade

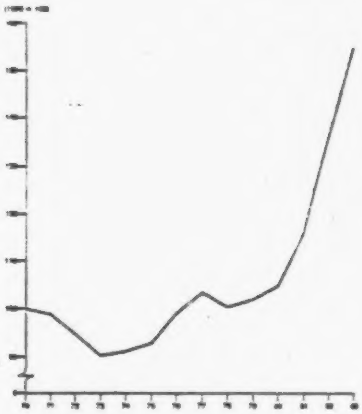
(Jan.-Oct. 1984, Annual Rate)

(All Figures in $U.S. Billions–Imports f.a.s. or customs value)



*High technology goods as defined by Commerce Department, definition no. 3. Imports c.i.f.
Source: NAM, from Commerce Department statistics.

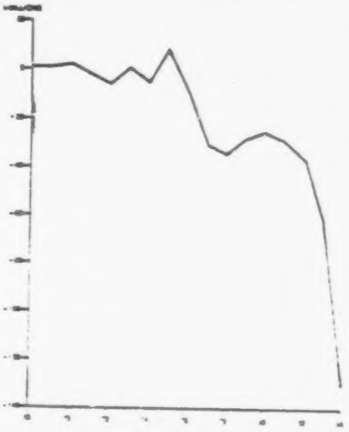
Exchange Rates, U.S. Dollar Relative to Currencies of 67 Countries (1970 = 100)



Source: U.S. Department of Commerce.

EXHIBIT 4

Trade Deficit, Merchandise Trade Balance (U.S.) (Billions of dollars)



Source: U.S. Department of Commerce.

from: GLOBAL COMPETITION, THE NEW REALITY, Vol. II of
the report of the President's Commission on Industrial Competitiveness

cause of our difficulty, and there is little chance of American industry becoming truly competitive if nothing is done on this front.

I referred earlier to the President's Commission on Industrial Competitiveness and to the President's Task Force on International Private Enterprise. The recently released reports of these groups should be required reading for every concerned citizen. We should agree that "America must take the challenge of competitiveness as the economic agenda for the next decade." Secondly, we should share the Commission's views with respect to the four major recommendations of the report, namely, that:

- we need to do better in creating, applying and protecting American technology;
- we need to reduce the cost of capital for U.S. industry;
- we need to develop a more skilled, flexible, and motivated work force; and
- we need to make trade a national priority.

I would like to concentrate this morning on the last of these recommendations, trade as a national priority. The Task Force on International Private Enterprise headed by Dwayne Andreas closely paralleled the Young Commission in this area. The Andreas group said there was a need to elevate international economic policy to a level comparable to national security. We agree with that, and we agree with John Young's comment in his letter of transmittal to the President: "The competitiveness challenge calls for the leadership only you can provide."

Commitment to Competitiveness

Above all we need a commitment to competitiveness--articulated by the President, given substance by the executive agencies and the Congress, and understood as part of our national purpose by the American people. We want Americans to have the best jobs within the context of a U.S. economy that continues to be a powerful, buoyant force in the world.

The first expression of this commitment could be the creation of a Department of International Trade & Industry. Both the Young Commission and the Andreas Task Force found the present method of formulating U.S. trade policy fragmented and unsatisfactory. A trade department should help the government confront the major tasks that government must confront if the United States is to respond successfully to the challenges of trade and competitiveness.

The Young Commission has pointed out that most of the job of being more competitive falls to the private sector. That is true, but we need to avoid thinking in terms of a false dichotomy. America does not compete in the world as a bureaucracy or a collection of firms. We compete as a society.

Case Examples:

We recently had a briefing from the chairman of one of our member companies, a company which, in his words is a medium sized, medium technology company. The firm is feeling a lot of pressure from imports from the Pacific rim countries, whose products are selling in the United States at prices that are 35 to 45 percent of the U.S. companies prices. In fact about 60 percent of this NAM member company's products compete with low cost foreign imports.

The company has a policy to deal with the problem. "Our policy," the chairman said, "is to stand and fight." Management has explained to the employees that smokestack America is not dead, that their firm has a future, but it is a future they have to fight for. The company has taken a lot of steps, some legal, some in terms of corporate organization. I think it is worth listing a few of them:

- o The U.S. firm discovered that there are no less than 14 different companies in Taiwan and Korea imitating its products. It has begun a determined effort to prosecute those who violate its trademarks and other rights. And they have worked to educate both U.S. Customs officials and the public so that they are alert to fraudulent goods.
- o The firm has dramatically reduced its inventories and improved its cash management.
- o They have reduced operating expenses generally including a 24 percent reduction in employment since 1980.
- o They have re-aligned their pricing so that extra services in support of their products are charged separately, in that imported products don't provide those services as part of their lower prices.
- o They have cut out whole layers of management.
- o They have improved productivity by new investments.
- o They have shifted some corporate assets to product lines that for one reason or another are not as vulnerable to foreign competition.

As an appendix to my testimony, I have attached a reprint from the March 3, 1985, New York Times which cites five other examples of companies trying to be competitive with the "Muscular Dollar."

Exchange Rates

These actions have kept them in the ballgame, but without an improvement in the exchange rate picture, they will probably have to begin more sourcing and production overseas. The "super dollar" is at least half the competitiveness problem, and we cannot afford to reject out of hand any constructive action or policy to deal with it. It is wholly unrealistic to argue that there is no link between the actions of government and the behavior of the financial markets. On February 21, the President praised the high dollar in his press conference, and in the days that followed it went still higher. On February 26, Federal Reserve Chairman Volker took the opposite tack, and the pressure on the dollar eased. The burden of the highly valued dollar hits farmer and manufacturer together, and our government in recent months has begun to take steps toward bringing the dollar into line with the other major currencies. It must make it clear that it will do what needs to be done to achieve that result. At the least this will include:

- a serious deficit reduction package in the FY '86-88 budget path.
- an expressed willingness to intervene in foreign exchange markets which become "disorderly" and where intervention can be "helpful" -- to use the Treasury's criteria.
- greater cooperation with the central banks of the other key currency countries.

Parenthetically I would note that it is much easier for the United States to work now to bring the super dollar slowly back to earth than it will be to prop up a dollar that has fallen precipitously.

Other Measures

At this point I would like to offer some of the other measures that the U.S. Government can take to improve American competitiveness. These might be divided into four categories:

i) eliminating the barriers to U.S. exports that we ourselves have erected;

ii) improving the rules of international trade;

iii) expanding U.S. access to foreign markets;

iv) making our determination to be competitive and our insistence on fair treatment clear to all.

U.S. Export Barriers

There are several export barriers in U.S. law. We have lived through, but not fully recovered from, the immense damage caused by our unilateral grain embargo and our sanctions imposed on the trans-European gas pipeline. But we still suffer from the doubts on our reliability as exporters who can fulfill contracts, especially given our approach to export controls. The President's Commission on Industrial Competitiveness has put this problem in perspective:

> Today, foreign policy controls are estimated to cost the U.S. economy $4.7 billion annually [in lost exports]. . . . national security controls are estimated to cost us another $7.6 billion in lost sales.

That is $12.3 billion in lost sales or one-tenth of the U.S. trade deficit. It is our hope that a new Export Administration Act, one that more clearly recognizes the importance of exports to the U.S.

economy and U.S. security will result in fewer controls and more sales. We urge prompt Senate action on the bill, H.R. 28, now proceeding through the House Foreign Affairs Committee.

There are of course other legal barriers to competitiveness, including the present vague language and heavy penalties of the Foreign Corrupt Practices Act, and the restrictive rules governing the Arab Boycott problem. I would suggest, though, that if this Congress can agree on an export-oriented Export Administration Act it will have contributed greatly to a more competitive America, especially if it helps reassure our overseas clients that we can be counted on to fulfill our contracts and will not unduly impose extraterritoriality in U.S. laws and regulations.

Improving the International Trading System

The call for a new round of multilateral negotiations, expressed by the President in the state of the Union Message, was welcome. I referred at the outset to stresses in the international trading system. These are a reflection of the fact that the realities of trade have outstripped the basic international law of trade, the General Agreement on Tariffs and Trade. The GATT system has been partly responsible for the eightfold increase in world trade that has occured since 1950 and the commensurate increase in the world's standard of living. But the GATT has begun to fall into serious disrepute, largely because business people and officials have lost faith in the GATT's ability to provide meaningful discipline over the large variety of trade distorting practices that proliferate in the modern commercial world. In the coming months we shall be working with our members to develop a better statement of NAM's objectives for a new round, but at the least these would include:

- o greater discipline over distortive industrial policies, especially in the high-tech area;
- o a better dispute settlement mechanism;
- o a safeguards code that has more transparency if not more teeth. Industry-to-industry agreements that restrict trade are just as disruptive as government-to-government agreements. The GATT needs to take note of them so that countries, like the United States, which do not participate in such agreements, but are affected by them, can protect their interests;
- o a new hard look at the Government Procurement Code;
- o real discipline in the counterfeiting area and in general better international protection for intellectual property rights; and
- o a meaningful set of rules governing trade in services.

Access to Foreign Markets

The Trade and Tariff Act of 1984 requires the U.S. Trade Representative to prepare a list of foreign barriers to U.S. trade and to give an indication of the importance of each. It could be that there will be some surprises there. At the moment, however, our assumption is that the greatest potential and the most serious barriers are in Japan. We are not in a position to second-guess the Administration in its current negotiations with Japanese officials on the access that U.S. firms have in certain Japanese markets, namely, those for electronics, telecommunications equipment, wood and paper, and pharmaceuticals. From our perspective, the

Administration has played it fairly well. They have let the Japanese know that there is a problem and that we expect them to solve it.

Personally, however, I am not optimistic that we will see anything like a $10 billion improvement in U.S. access to Japanese markets. I'm not sure, for instance, whether we have obtained any tangible concessions from Japan for our decision not to press for continued voluntary automobile export quotas. But given the level of U.S. business frustration with Japanese trade practices, if there is no significant improvement, there will be a reaction. I am not sure what that should be, but we must convince the Japanese of our determination to see a more even distribution of the benefits of trade--including employment benefits as well as choices for consumers.

Determination To Be Competitive

EximBank. As I said earlier, what our country needs is a commitment to be competitive. Unfortunately, there are several key areas where we are sending exactly the wrong signal, such as export finance. The Export-Import Bank of the United States provides only a fraction of the assistance that foreign governments give their exporters. Roughly 10 percent of American manufactured exports benefit from official export credits. The comparable figure for Britain is roughly 55 percent, 35 percent for France and 40 percent for Japan.

American producers are losing foreign sale after foreign sale because we cannot keep up with the policies of our competitors, especially with their generous use of mixed credits as inducements to their foreign buyers. The American view of aid is that it should benefit the recipient. The French view appears to be that it should benefit French exporters. The rhetoric of American officials would indicate that the United States is determined to neutralize the role of mixed credits in international economic competition. But we have not provided the funds to achieve this goal, and no one is fooled.

To the contrary, the current budget proposals would weaken Exim's ability to provide even the help it now provides. That is not the type of commitment needed.

Trade Law. The idea that there should be vigorous enforcement of U.S. trade laws has long been the firm policy of the National Association of Manufacturers. Dumping and subsidies should be met with the full force of the antidumping and countervailing duty laws, but I am not inclined to suggest that this has not been the case. Our impression is that the Commerce Department and the International Trade Commission have worked well together in a difficult period. I would point out, however, that here too the exchange rate has adverse effects on U.S. companies. Take the case of the foreign producer whose price, at fair exchange rates, is roughly equal to the U.S. price. That producer would probably need to dump product here to undersell his U.S. competitor and so get a toehold in the U.S. market. That is not necessary today. The misalignment of the dollar and other currencies gives him the same advantage without forcing him to resort to dumping.

So long as one's focus is restricted to countervailing and antidumping, the question of resolve does not really arise. It does arise in connection with Section 301 of the 1974 trade act, which deals with unfair trade practices by foreign governments and which is wholly discretionary with the President. We have no specific action to recomend here, but it is our view that a Section 301 fillip to the Japanese or another trading partner may be much healthier for the trading system as a whole than any further erosion in the American business community's confidence that U.S. trading interests will be protected.

Conclusion

Americans are problem solvers. We at NAM do not believe that the problems before us are insurmountable. But they are very large and very important. They can only be overcome if they are squarely addressed. Bob Hormats talked to you last week. I believe he referred in his testimony to the extreme good fortune of the United States in enjoying freedom, prosperity and power all at the same time. If we do not make a credible commitment to competitiveness, each of those blessings will be in jeopardy.

Thank you.

[From the New York Times, Mar. 3, 1985]

Struggling to Live With a Muscular Dollar

The strong dollar has changed the way American companies do business:

The Huffy Corporation in Miamisburg, Ohio, is the country's largest maker of bicycles, and it has a peculiar problem with the dollar. The currency or its chief competitor, Taiwan, is tied to the dollar, so both rise and fall together. Thus Taiwan faces the same difficulty in selling to foreign markets that American companies do, and it concentrates its efforts on the United States. "Four or five years ago, we built a plant in Ponca City, Okla.," said the chairman of Huffy, Stuart J. Northrop. "We've had to close that facility, and it's up for sale."

Cincinnati Milacron Inc. is one of the world's leading producers of machine tools. To keep its domestic costs down, a spokesman said, "we're increasing our worldwide sourcing"—buying the materials and components the company needs from abroad, rather than from American manufacturers. In addition, it has hired subcontractors in Japan to make its robots for the Far Eastern market. "That market is virtually closed to us because of the yen-dollar gap," the spokesman said. The company has also licensed a major Japanese company, Fanuc, to make its injecting-molding machine, used to make plastics.

The Measurex Corporation in Cupertino, Calif., makes computerized manufacturing systems, mostly for the paper industry. Ten years ago, well before the rise of the dollar, Measurex opened a factory in Waterford, Ireland, where it assembles its systems for sale to the European market. But in January, because of the dollar, the company switched to "local currency pricing"—quoting its prices in foreign currencies rather than dollars, to remain competitive, even though that means lower earnings in terms of dollars. "We can't demand a fixed dollar price any more," said Robert McAdams, Jr., senior president for finance. "The competition won't allow us to do that."

The Brunswick Corporation in Skokie, Ill., is a diversified manufacturer whose products include the Mercury and Mariner brands of outboard motors. "Over the past four years, our motor sales have declined, mostly because of the dollar," said Max E. McGrath, vice president for finance. Japanese competitors—Honda, Suzuki, Yamaha—have captured much of Brunswick's market. "We're dealing with it," he said, "primarily with an extensive cost-reduction program, so when we deliver our engines our goal is to meet their price." Brunswick is also importing more engines from Japan under its own label.

The U.S. Shoe Corporation in Cincinnati is the country's No. 2 supplier of shoes, the producer of such brands as Red Cross Papagallo, Capezio and Liz Claiborne. Its competition with imports predates the rise of the dollar. It has been manufacturing overseas for more than 20 years, and imports account for 65 to 70 percent of women's shoes it sells in the United States. With the rise of the dollar, a spokesman said, its import business has been thriving, and its domestic manufacturing waning. It has laid off workers in Ohio, Indiana and Kentucky.

The Briggs & Stratton Corporation in St. Paul is one of the nation's best-known makers of gasoline and diesel engines. "We get pretty emotional about the dollar," said L. William Dewey, executive vice president. "We used to have 26 percent of our sales outside the United States. Right now, it's less than half that. We attribute it almost totally to the dollar." Briggs & Stratton's strategy for dealing with Japanese competitors in America is "zero pricing," which means the company does not raise prices. Overseas, the company, like Measurex, has switched to "local currency pricing." In the 1960's, Mr. Dewey said, the company considered opening a manufacturing plant abroad and decided not to. "It's a strategy we have to seriously consider again," he said.

Copyright 1985 by the New York Times Company. Reprinted by Permission.

The Chairman. Thank you very much, Mr. Trowbridge.

Gentlemen, we will commence questioning with 10-minute limits on each one of us as we rotate that opportunity.

Mr. Andreas, I appreciated very much your testimony and likewise again your mention of the proposal made by the task force that you chaired to establish an Economic Security Council. Let me ask for your frank appraisal, on what the reaction to this has been.

My own impression, having read press accounts of your report and its receipt, is that it ran into immediate resistance and/or indifference, and as a result not much is occurring on that front. Can you be more reassuring, or would you give an appraisal of what has happened to the report as well as the specific thought of the Economic Security Council?

Senator **Mathias**. Mr. Chairman, while Mr. Andreas composes his thoughts, which he may not ever have to do, let me just remind you, or let me just suggest to you that it has not run into a total wall of indifference. The Governmental Affairs Committee did, in fact, adopt an amendment which provided for an Economic Security Council to deal with financial, economic, and trade matters as a part of the Department of Trade legislation which was proposed last year.

Now, that did not become law, but this is a very important concept. It has gotten at least some support, and I think had the trade bill moved on the floor, it would have gotten greater attention.

Mr. **Andreas**. I would say this, Mr. Chairman. No effort was made to deal with giving any publicity or to get any kind of treatment whatever in the press about our report, because it is just the nature of it. It is not something that the public would take a great interest in, so I do not think there is very much significance that the press did not express any enthusiasm about it.

I do know that we delivered it to the President, and the following day Ed Meese said to me that the President had taken it home with him to his private quarters, and had come back the next morning and indicated that the one part of it that he was interested in was that part of pulling all the economic policy together which is presently fragmented.

Don Regan, former Secretary of the Treasury, has indicated to me, although I have not had any formal conversations with him, but he has indicated to me on two occasions that his people are studying it, and that he is hopeful that some version of it will be forthcoming.

I understand that Roger Porter in the White House is assigned to study parts of it.

So, it is alive and well, but it runs into a general feeling around Washington now that no more Government agencies are needed. It is a little bit like swimming against the stream. What we are saying there basically is that we have 10 or 15 agencies dealing with foreign governments, and they should all get their direction from one place, and it should follow a policy that is in our own interest.

We found that nobody in our Government has all the muscle available to deal with foreign governments. The STR is doing an excellent job in our opinion on negotiating, but they no longer have that muscle of the White House behind them which is needed.

We talked with one head of state who I should not mention but who gave us this little example. He said, we had a sugar contract with Japan in our country when the EEC dumped sugar on the market and brought it all the way from 20 cents down to 5 cents.

The Japanese quit picking up their sugar. He said, I went to the highest level for this purpose in Tokyo and simply said one thing. If you do not pick up our sugar, we will close our borders to automobiles on the 30th of this month. Instantly, within 2 weeks the ships came in to pick up the sugar.

That is just an example, a crude example of the way business is done. What I am saying is that our Government has no way of doing that, and we should be doing that, and if we do not, they are going to pick us like a chicken.

The CHAIRMAN. I thought that the testimony you gave today, and you have done the same in other forums, was impressive again in emphasizing the mercantilist attitude of other nations. Clearly if this is true, and I think the evidence mounts in many instances that it is, if we are unprepared in a central way to move as a government, as you suggest, we will be plucked like chickens in the process.

I am hopeful that Mr. Regan and Roger Porter and others are thinking through this carefully, but I must say that what I had envisioned as I read your report and talked to you originally was an Economic Security Council of almost the same authority as that being headed by Bud McFarlane and other portions of the White House.

In short, from Mr. McFarlane and his associates, the President is receiving advice on military security aspects of the country. It is very important advice. But there is not the same sense of urgency with regard to the economic matters.

One of the reasons for holding this set of hearings in the sequence we are doing is to make the connection between that national security and the economic. After we had the global view of our Secretary of State and Defense and others who have served in those positions in the past, and then thinking through in four sessions the Soviet-American relationships, we have moved to the economic relationship, which I think many members of the committee see as having grave import, maybe just slightly following the Soviet-American situation in the strategic sense.

This is why I take this opportunity and the platform of the hearing not only to commend your effort, but to say that I have been somewhat disappointed that the urgency of this sort of thing is not perceived because all of you are pointing out that our situation, whether it is manufacturing or services or whatever we have to sell, is deteriorating.

It is disastrous. And there are very great political problems building in this country domestically, quite apart from the economic problems that we are taking a look at.

Let me follow up, Mr. Andreas, with your comment. I am sure this is literally true, but correct me if it is not. You are suggesting the EEC is subsidizing the sugar situation to the point that they are paying producers in the EEC 27 cents a pound and selling it for 4 cents?

Mr. ANDREAS. That is absolutely correct. Strange as it seems, that is true, and they are dumping it day after day, and have been doing so for the last 2 or 3 years, destroying the economies of their former suppliers and the Third World countries who produce sugar. They have deprived those countries, according to a USDA study, of somewhere about $2 billion in income per year by their dumping operations. A recent study by the highly respected Economic Perspectives, Inc. reveals that had 1984 stocks been at normal levels, the income of the developing countries would be up by $6 billion. Also, our foreign aid expenditures would be down sharply and there would be greater political stability.

The **Chairman**. Do you have available, instances such as this of what are fairly visible and well known instances of mercantilism or even in this case almost a multinational form of it?

The EEC, after all, is not a single country but a collection of countries in which the committee might be advised of specific instances in which a governmental response on our part would clearly be in order, and in fact without a governmental response on our part destruction of a market is very likely.

It seems to me we would get to the heart of the matter rapidly in ways where the American people might not be energized by a Task Force on Governmental Reorganization, but most people are energized by a thought that sugar is being subsidized at 27 cents and sold at 4 cents. They can understand that differential rapidly.

When you move that into other agricultural products, it becomes even more exciting.

Mr. **Andreas**. Yes, it is one right after another. The EEC has an export subsidy program for flour. They have taken $13 billion worth of flour business away from the United States in the last 12 years. They have taken 70 percent of our export business away with pure cash export subsidies.

The same thing has happened with chickens. They have subsidized chickens by 25 percent and taken away more than half the U.S. export chicken business. There is one example after another.

My company owns a half-interest in a firm in Germany that does $12 billion worth of business from third countries to third countries. Last month that firm sold 700,000 tons of French wheat to the Soviet Union for $17 a ton below the American price with a $22 a ton subsidy coming from the EEC.

Now, I am only giving you just a small example. There are hundreds and thousands of these cases. In the case of flour, our STR to their everlasting credit recommended 2 years ago that we go ahead and sell a million tons of flour to our historical customer, Egypt, at the French price.

We did it, but we got so much flak from all of these countries that it was not continued. We should have a policy on that. In the case of sugar, a control policy was forced upon us, because that sugar dumping would have put our cane people and our beet people right out of business, and it would have cost our corn farmers $1 billion had not this country put up some reasonable kind of quota systems.

We feel that it is the job of the Federal Government, never mind that they are trying to deregulate, it is the job of the Federal Government to run interference for free enterprise and not let socialist mercantile states because they are good friends and allies run private enterprise out of business.

Our farmers and our workers today are competing with the treasuries of those countries. They are not competing with their counterparts. They are competing with the treasuries of those countries.

The **Chairman**. Thank you very much, sir.

Senator Cranston, do you have questions of the witnesses?

Senator **Cranston**. Yes, Mr. Chairman; thank you very much.

Mr. Trowbridge, you noted in your testimony that the exchange rate misalignments are probably the paramount factor in our adverse trade situation. Other witnesses earlier have indicated that it is not likely that we can expect any significant change in these alignments in the immediate future, in view of our problems with the deficit, which we are trying to cope with, but which will not happen overnight.

In view of the fact that we cannot expect any early remedy on the deficit, what do you expect to happen in relationship to trade, particularly with the import of autos, in view of the recent decision by the administration?

Mr. **Trowbridge**. Senator, I do not anticipate a change in direction from what we now see in the overall trade deficit which grew, as you know, to $124 billion last year, and as I think Secretary Baldrige and others have calculated, may reach $150 billion this year.

We are watching the outflow of American jobs and American production in very substantial and rather permanent form, I am sorry to say. American companies, no matter how much they do, and I have cited some examples of internal changes that they could make to become more competitive—if they get 25 to 35 percent of their production costs out of their product and then they step up to bat and find that the dollar is against them by a 40 percent factor, they certainly are not going to be competitive.

This is unfortunately a trend which will continue as long as this phenomenon continues.

Senator **Cranston**. Thank you very much.

Dwayne, in your testimony you say that your task force recommended the doubling of Food for Peace financing above the fiscal 1984 level to meet humanitarian needs.

Then you referred to Government studies which show that this can be done at no cost to the Treasury. You referred to substantial savings in efficiency payments, loan acquisitions, storage process, et cetera. Can you amplify a little bit on that, or tell me where those studies are?

Mr. **Andreas**. Yes; there are three of them. One study was done by the economic section of USDA, which is available from our task force staff. It demonstrated that the savings and target price payments, the savings in storage and interest, and the taxes that are generated by doing the business makes a Public Law 480 transaction have a positive effect on the U.S. budget.

Another one was done by the Congressional Budget Office, which came up with the same conclusion. Another one was done for Senator Danforth, which I have just read in recent days. I am sorry, I cannot just tell you where that one came from, but I think it came from GAO.

They all indicate that the business generated and the savings in the farm program paid for the sale of food. In addition to that, the Public Law 480 has been a vast market development program.

Many countries which were on Public Law 480 for 4, 5 or 8 years are now big cash customers, so as a market development program, it has been very successful, and it is the feeling of our task force that the cheapest way to bring an oxygen bottle into the farm economy is to start moving that stuff out of this country to people who need it.

Furthermore, to head off the very great risk that some day we have to go once again before the whole world and pay our farmers to abort the production of food, which is something that though we know it was needed as a way of paying damages to those farmers for what was done to them with the embargo, nevertheless we are ashamed of it because we should not be paying people to idle themselves and abort the production of food in a starving world.

Senator CRANSTON. How swiftly would those compensating revenues come in?

Mr. ANDREAS. Well, it would take a little time. It is not short range, but it is within a period of, say, 2 years, because the target price payments cut the storage and interest immediately, and it generates business, shipping, processing, all kinds of business on which people pay income taxes.

Senator CRANSTON. I am very impressed with those figures and want to examine them very closely and carefully. Our problem is the terrible short-range problem we have of dealing with this year's deficit and showing that it is going down. It is tough to take into account revenues that will come into effect in 1, 2 or 3 years.

Mr. ANDREAS. The Office of Management and Budget has the same problem that public corporations have. They are preoccupied with this quarter's figures.

Senator CRANSTON. Exactly. That is a major problem in the corporate world as well as in the Government world.

I have one other question on figures. You refer to the $100 billion annual bill for defense costs for the EEC and Japan which enables them to finance economic trade warfare. The figure that I had in mind for NATO was $33 billion that that is costing us. What are the other components of that $100 billion that you referred to?

Mr. ANDREAS. I am sorry, Senator. I will have to apologize. I do not have a breakdown of those figures. We got that from one of our studies. I simply copied it out of there. I thought it was an all-inclusive figure for what we spend in the Pacific and the Atlantic on defending other countries.

At the moment I do not have the backup figures.

Senator CRANSTON. Would you supply that for the record?

Mr. ANDREAS. I will supply that. You bet I will. And if it is wrong, we will just correct it.

[As of the date of publication, the information referred to had not been supplied.]

Mr. ANDREAS. But the point would be the same.

Senator CRANSTON. There is one general question that I would like to pose to whoever would choose to answer, or I would welcome any comments any of you would choose to make.

We have the problem of the overvalued dollar which comes from the deficit, or a good part of it presumably, leading to the trade imbalances, but on the other hand the high interest rates that accompany all of this lead to this large foreign investment where they are in effect financing our deficit.

So, we have a plus as well as a minus out of that situation. If ever that tails off, then we could be in very serious trouble, and have stiff competition for money here that could lead to elevating interest rates. What do you foresee occurring there? Do you foresee a time coming soon when foreign capital will cease coming into the United States, and if so, what consequences may we expect?

Mr. **Andreas**. I think that really is based on human behavior. I feel that our studies indicate that a lot of the flow of capital into this country comes from the perception all over the world that we are now on a conservative roll, and that it is a safe haven for capital, and it may have more to do with psychology than actual trade. So, that case, outguessing the behavior of people is extremely difficult, and I would be hesitant to do it.

What we do see as a more real problem is the danger that some of these countries with—there is a total of $800 billion debt in the Third World, and it is doubling every 6 years with compound interest, so it is going up very rapidly, and we feel that there will be a crisis on that particular thing, and that we are not really prepared to handle that crisis.

One of the things we recommended, many of these countries who have a huge debt, the Government is not disposed to just go in and save the bankers. That has been indicated. It is not politics. It may not even be—I do not have an opinion on that. But by putting these agricultural products into those countries on Public Law 480 terms, accepting other currencies for them, which is going to be in the next farm bill, I believe, according to Senator Helms, if we could sell goods and accept those local currencies when the dollar shortage is so acute, and if we could sell them on credit terms, it would bring some life in under those economies, enabling them to pay their interest charges and maybe keep their debts alive. Otherwise some of these countries will be defaulting.

Senator **Cranston**. If we do not correct our own deficit problems sooner or later the people who are now putting money into this country feeling that it is a safe haven are likely to become concerned about that safety, are they not?

Mr. **Andreas**. Inevitably. It is only a question of when.

Senator **Cranston**. Thank you very much.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Cranston.

Senator Mathias?

Senator **Mathias**. Thank you, Mr. Chairman.

I think it illustrates the usefulness of these conversations. We have identified Mr. Andreas' interest in a security council level economic forum that will bring together all of the interests that ought to be consulted before a serious financial or economic decision is taken.

I would ask unanimous consent at this point that the amendments that were adopted in the Governmental Affairs Committee which provided precisely for such an Economic Security Council be included in the record at this point, so that we can all be advised of where we are going.

The **Chairman**. Without objection, so ordered.

[The material referred to follows:]

Senator Mathias offered five amendments. The first would create in the Executive Office of the President a Council on International Trade, Economic, and Financial Policy. The purpose of the Council would be to coordinate the nation's trade policy with our other international economic policies. The Council, with the support of an Advisor to the President for International Trade, Economic and Financial Policy, would seek a balance among these related policies to avoid the disincentives to trade, such as exchange rate misalignment, that our businesses face currently.

The second amendment would expand the congressional findings in the legislation to include the maintenance of United States leadership in international trade liberalization and expansion efforts and the reinvigoration of U.S. competitiveness as principal national goals.

The third amendment would create a Deputy U.S. Trade Representative in the Department. This individual would have a clear mandate to exercise the authority of the Secretary in trade negotiations or trade policy-making should other demands at any time prevent him from meeting all of his responsibilities.

The fourth amendment would establish a specialized career service to attract and retain in the Department highly experienced and qualified trade professionals. The amendment responds to the widely recognized need to develop a career trade corps to effectively match the veteran trade professionals of our major trading partners and competitors.

The fifth amendment offered by Senator Mathias would require Executive Branch rules and regulations and legislative proposals recommended by Committees of Congress to include impact statements indicating how these actions would affect our trade competitiveness.

The five amendments were offered in block and accepted in a roll call vote of five ayes and two nays.

Senator MATHIAS. I will send to Mr. Andreas and also to Mr. Roosa and Mr. Trowbridge if they are interested, copies of those amendments.

I do not want to leave the chairman under the impression that they were unanimously adopted in the Governmental Affairs Committee, or that there was great rejoicing over it, because we adopted them, as I recall, by a margin of one vote, but they were adopted.

The principal opposition came out of the Commerce Department. I think that is useful to know, simply because it provides a target for some further work as we proceed on what I believe is one of the most necessary structural reforms that we have to undertake in government.

I rejoice that you have been working on it at the other end of Pennsylvania Avenue, and I hope that maybe if we can work together we can do a little bit better job.

Mr. ANDREAS. It might interest you to know that Mr. Baldrige has indicated to me that he has studied that, and that he is inclined to favor some form of that council.

Senator MATHIAS. That leads me to hope that the miracles that have occurred on the road to Damascus have not yet ceased, because he was certainly adamant in his opposition the last time I talked to him on this subject.

Mr. TROWBRIDGE. Senator, we have been very strongly in favor of the proposed Department of International Trade and Industry, but I see nothing inconsistent with that and a strong presence at the White House or a coordinating role there as well. I think both could serve a very important purpose of underlining the importance of the issues and the need for a coordinated attack and policy framework.

Senator MATHIAS. Precisely. In the best of all possible worlds, a President would have the time, the knowledge, and the inclination to sit down with his Secretary of Commerce, the Secretary of Treasury, the Secretary of State in the late afternoon over a trade issue and they could work all of these things out at a very high and amicable level.

But we all know that we do not live in the best of all possible worlds, and you need some kind of structured method to make sure that the loose ends are all tied up. I think this is something that we all really need to work on, and we will see that you get copies of what was done here.

Mr. ROOSA. If I might make one point, Senator, I would add that I think the idea is certainly a great one. We improvised the same sort of thing during the Kennedy administration, and got a lot of benefit out of it. But it was not formalized.

The one thing that I take Bud McFarlane's performance as a good illustration for is that the role is that of coordination and supplying information to the President, not controlling. That is, the roles of the Secretaries must also be preserved in this. It is a matter of assuring that they have to get together.

I think in that sense such a council, headed by someone who has the ability but also the relative anonymity that Bud has is the ideal answer. It needs this kind of implementation. It needs to be a person, of course, with the full confidence of the President.

That would go on to a point that I made before you arrived, Senator. I think we need this not only to achieve the kinds of, to put it crudely, straight arming of other countries when we have deals that have to be made where concessions have to be achieved because they are imposing obstacles and barriers. We need it in order to more effectively achieve the kind of coordination in economic policy among countries that is always mouthed in every summit.

You get a two-sentence line about harmonizing economic policy, and then they repeat the same sentence at the next annual summit, and then there will be one or two meetings of a few Secretaries of the Treasury accompanied by a few central bank presidents, and piety comes out.

What we really need is this facility so that within our Government we have an entity, a council, so that we have the facility to use our leading role in the world economy to be able to negotiate on all kinds of broad issues, not just the individual deals, but in terms of the shape of economic policy and the way in which the policies of the leading countries can be harmonized to live together.

Senator MATHIAS. You have expressed exactly the spirit in which my amendment was offered in the Governmental Affairs Committee, not to create a tsar, but simply a forum where the various considerations that should be taken into account are given an opportunity to be looked at, discussed, and weighed and a balance finally achieved.

The various departments and agencies that would be represented in the council should come in as equals, and no one should dominate. I think Bud McFarlane is an excellent example of the way the shop should be run.

Secretary Trowbridge mentioned the competition we have created by our own decisions in imposing embargoes. Last year Howard Baker and I went to Brazil and saw huge fields of soybeans where in a previous visit to Brazil I had seen only virgin soil, never touched by the plow.

Well, the United States is responsible for that huge soybean production just as directly as if the President had gone out and sowed that crop himself.

Mr. Roosa. Yes.

Senator Mathias. Somebody ought to look at the downstream effects of these decisions. We lose opportunities here on the Hill. We undertake in this committee, Mr. Chairman, to approve tax treaties and other international agreements which would be perfect opportunities to link various considerations.

There ought to be some place where when we make a decision we look at the downstream effects and we look at all of the interrelated effects of that agreement and maybe unrelated opportunities that come along at the same moment.

Mr. Andreas. I feel if you add such an entity, none of the three embargoes would ever have taken place.

Mr. Roosa. That is for sure.

Senator Mathias. Well, as they say up in the Pennsylvania Dutch country, too soon we grow old, too late we grow wise. I think that is what a great many of us are concluding. I am believing that embargoes hurt the embargoer more than the embargoee.

Mr. Trowbridge. That has certainly been the case in those examples.

Senator Mathias. Mr. Roosa, in your statement you made the interesting suggestion that a reduction of the U.S. deficit would lead in the short term to attraction of foreign investment to this country. Did you mean to make a distinction between the short and long term?

Mr. Roosa. Yes, it was only a concession to my old friends in the Treasury who keep saying this. I wanted to head them off. I really do not think this sequence is very long. But the implication is, along with the point that Dwayne made about the impression abroad that this country is for the time being on a roll and everybody thinks it is attractive, it is not just interest rate spreads, it is the whole impression that we are a flourishing economy, private enterprise, fully democratic, the ideal place to put money, and therefore if deliberate and effective action is taken to reduce the deficit, which is what most foreign observers are worried about at this stage, this, for a moment, at least, will be a new sort of affirmation to them that, well, the United States has things under control again. OK.

But I think as soon as the effects have spread through, once the program is under way and the deficit itself begins coming down, and you begin to see that interest rates begin to come down, so will the exchange rate. It is just the short-term that a reduced deficit might push up the dollar.

Therefore, just as in so many other things, I would think when the moment comes that we really see action, if that action has been sold on the basis that on day one you act to cut the Government deficit and on day two the foreign deficit goes down, there will be some disillusionment. But let us say day three comes, and then deficit reduction at home will lead to deficit reduction in the balance of payments.

Senator Mathias. I see that my time has expired. Gentlemen, I thank you very much for your contribution and for your time. I will send that amendment to you as I promised.

Thank you, Mr. Chairman.

The Chairman. Thank you very much, Senator Mathias.

Gentlemen, I would like to take advantage of your being here as sort of wise men together in a panel to ask two questions that are suggested by testimony of Mr. Roosa in particular.

I am intrigued as to your judgment as to why more investment by U.S. firms has not occurred, say, in Europe during this period of time. I understand with regard to Japan that there may have been more blockages in terms of ability to acquire assets.

But given the fact that all of these assets would appear to be very inexpensive and are becoming more favorable all the time, why would not aggressive American businesses have made an enormous investment in this period of time?

Mr. **Roosa**. Senator, I had exactly that question, and every so often I have to work for my living. One of the things I do is to talk to groups of clients. We had 15 corporate treasurers for dinner last week, and I posed this question, and I polled the table in order to get responses, because I am bewildered why they have not taken advantage of it.

Of course, one initial reason is, those who are active overseas realize that their current earnings are always being written down when they translate them back into dollars because of the high exchange rate. So, the first blush is to say, well, my gosh, we are writing down our earnings, why sink in any more? But that is only a first blush.

Then, when they get into really thinking about it—and this is the difference between, let us say, an absentee board of directors and an actual corporate treasurer; corporate financial people say they have to explore what are the obstacles now to being able effectively to operate. then you get a clear example of the sort of story that is repeated over and over again when you hear the European sluggishness described.

There is just too much rigidity, too many of the arrays of constraints in terms of lifetime employment once you hire someone or the problems of being able to manage your own firm without having to have a separate board of directors on which all of your employees sit. Too many of these new things.

Now, where there are established firms, many of them are getting along, but they have found enough difficulty that one after another finds that the operational environment in Europe is not all that attractive.

I tried to just pursue the argument with them a bit, and ask them, but when you can buy these things for half or two-thirds of what you would have had to pay for them in dollars even 5 years ago, and some of them are going concerns and some of them are in your own field, why not?

Well, I sit on a board where we did make that decision, and we did, we bought out—you will pardon the expression; this is an oil company, not me—but we bought out most of the stations of another competitor who was ready to get out of Europe for this reason.

I think that a sort of sluggishness is an example of the lack of that American zeal and creativity that we rely on. I find the only other answer is that things are looking so well here, why get into trouble any further abroad? You just do not have the same kind of conditions there in dealing with labor, in dealing with your own government, in dealing with markets. We will use what we have, and maybe we will expand within what we have, but trying to buy out other firms is too much trouble.

Mr. TROWBRIDGE. Senator, I would add that many of the major American firms are already in Europe and have been there for a long time, and to the extent that they are reinvesting, it is not that big a deal for them.

Second, some of our members have been to Europe, and in talking with members of the European business community or government leaders, they are confronted with a sense of awe as to the freedom of action within the American economy.

A German minister of finance said, "You know, to us, it appears that all you need in America is an idea and a garage, and you put yourself in business, and it takes us 18 months to get started." It is that kind of rigidity that Bob just mentioned that does turn off a lot of potential investors.

Third, there are, I think, some trend lines going in non-European directions which we ought to recognize, and those are toward the developing countries; the Koreas, the Singapores, the Brazils, the Mexicos whose economies are moving upward in their skills, whose work force is still at a low labor cost rate, but at a higher technological ability.

It is into those areas where an awful lot of American sourcing and now production is moving in order to take advantage of local costs and get away from the burden of the overvalued dollar.

The CHAIRMAN. Let me ask a second question. During our hearings on economic issues globally, we have heard, as you pointed out, how much of the capital on which we have relied in 1984 was supplied from abroad from the savings of the Japanese or the Europeans or others.

The thought is that somehow a bubble is growing, and that we do not know the extent of it, but that at some point it will burst, or maybe that is the wrong metaphor, that maybe it will deflate or incrementally decrease in size, but still the thought is that we are headed up in some direction and that we are going to come down.

Mr. Feldstein, I think, very graphically indicated, and he may or may not be right, that the currencies have gone up 70 percent at some point in time, that they will probably come down 70 percent. That may or may not be the case, but that is an awesome thought, that we would lose all of this in a net sense as it seeped out.

Without exception, most of our witnesses have given the impression that when this occurs, that is, when some change occurs in the wind, however dramatic or undramatic it may be, that then in this country, those who require capital, including the Federal Government, will be competing for whatever savings are in this country absent this large increase coming from somewhere else. Interest rates will rise because the demand will overwhelm the supply unless there is a dramatic change in our savings rate or we are just wrong, that the outside interests do not ever stop. They keep going up.

Is this your general impression, that we are almost fated for higher interest rates in a secular sense as this situation turns around? And without being overdramatic about it, it may not be vaulting upwards, but it is almost inevitable that there will be a competition for what remains of capital.

It will be fierce, and to the extent the Federal Government lowers the deficit, less fierce, but in any event with everybody wanting capital in this country a shortage that brings higher interest rates.

Mr. ROOSA. I certainly think so. It all depends on whether the President ever proves right. We have all been hoping for the supply siders to get started. His hope was that savings would increase, but it has not happened yet.

If we were to find some way either through nature from here on or through adaptation of the tax system, which, by the way, Ambassador Brock mentioned this morning, to take into account the need to raise the savings proportion, that might be the way to head it off and enlarge the pool from which these domestic requirements could be met.

Short of that, and given the way the savings pool is not rising now, I do not see any alternative to a fairly severe jolt. As a matter of fact, the risk I fear is that when it turns, you will actually have a run from the dollar which could be quite chaotic.

And in my testimony, which is much too long, but I let myself go, I said that I thought this was one place in which if we were organized for a coordinated intervention, that is one place where we would need it, and the United States would then be in a position of selling foreign currencies by drawing on our swap lines and selling foreign currencies for dollars in order to keep this from becoming a nosedive.

The CHAIRMAN. What tax changes would increase saving in your judgment? What significant changes could we make?

Senator MATHIAS. If you would let me intervene, Mr. Chairman, increased incentives to save without also exacerbating the deficit problem.

Mr. ROOSA. The most direct form is the switchover to a VAT, but I know that is anathema to a lot of people, but I think the value added tax, which in effect is an overall excise tax, is in principle the way to do it.

I have had that thought ever since I have been worried about whether we had enough savings. Doug Dillon and I floated that idea through an intermediary in a New York Times Magazine article in 1962. The article got shot down so fast I have not dared mention it since.

The CHAIRMAN. But here we are 23 years later in this area when it surfaces again.

Thank you very much.

Senator Cranston, do you have any other questions?

Senator CRANSTON. I have no further questions.

The CHAIRMAN. Senator Mathias?

Senator MATHIAS. Thank you, no, Mr. Chairman.

The CHAIRMAN. Gentlemen, we deeply appreciate your staying with us through this late hour. This has been a very important experience for all of us, and we thank you very much for your testimony.

Mr. TROWBRIDGE. Thank you.

Mr. ROOSA. Thank you.

Mr. **Andreas**. Thank you.

The **Chairman**. I would like to ask unanimous consent to make part of the committee record a thoughtful statement entitled "The Need for A Private Enterprise Approach for Development," by Paul Laudicina. Without objection, that will be added.

[The material referred to follows:]

Statement
on
The Need for a Private Enterprise

Mr. Chairman, it is a pleasure to offer the distinguished members of this Committee our views on the development potential of private sector initiatives in the Third World.

My name is Paul Laudicina and I am Director of SRI International's International Policy Analysis (IPA) group headquartered here in Arlington, Virgina. SRI International, formed in 1946 as the Stanford Research Institute, is an independent, non-profit research and consulting organization serving government and business clients worldwide. We in IPA have had the opportunity over the course of the last three years to advise our own government, as well as foreign governments and various corporate clients, on the opportunities for and constraints to generating increased investments of private capital in a number of developing countries.

It is our view that while much has been written and said about the disappointments associated with the Administration's private sector initiative in the developing world, tremendous positive development potential remains for a properly executed series of policies aimed at stimulating private sector growth in the Third World.

The case for sustaining and even expanding a United States-sponsored private enterprise initiative in developing countries is compelling. It is based on the need to acknowledge current and projected economic and political realities, including the following.

(1) The economic momentum generated during the 1970s by the dynamic international trading climate has for the time being run its course, and has been replaced by a prolonged period of slower global economic growth in the 1980s. Consequently, the "standard" policy measures of past decades appear to be less than fully effective.

(2) It has become evident that the size of the public sector in many countries had become excessive, to the point of exerting a major drag on economic activity. Budget deficit financing has led to inflation, balance of payments deficits and rising debt levels. These problems have become structual rather than cyclical in many countries, and have led to calls for greater discipline in public sector activities and for increased emphasis on private sector activities.

(3) A number of market oriented, highly competitive developing countries have demonstrated that systems which place a high priority on market forces and private enterprise are more likely to achieve positive growth rates than those which do not, and that equity does not have to be sacrificed in the process.

(4) A fundamental change has taken place in attitudes toward foreign direct investment in developing

countries. Host countries have revised their previously hostile view toward foreign investors, acknowledging that the political benefits of anti-foreign investment postures and policies are outweighed by the economic benefits foregone. In fact, in view of the relative stagnation in worldwide foreign investment flows, host countries have initiated aggressive incentives programs to entice prospective investors from competitor countries. Direct investment inflows have also come to be viewed as productive capital offsets to current account payments deficits.

(5) A fundamental structural change has taken place in the composition of capital flows from developed to developing countries. In the 1940s and 1950s, seventy percent of these flows were in the form of foreign assistance, with the remainder accounted for by private sector flows. These shares have been reversed; in the early 1980s, official development assistance has accounted for only about one-third of financial flows from developed to developing countries.

(6) The economic ability and political willingness of donor countries to maintain, much less expand, foreign assistance programs has weakened. Budgetary constraints have intensified and will continue to do so in the foreseeable future. For the United States, for

example, ODA as a percentage of GNP has fallen from a peak of about 2.5 percent during the Marshall Plan era to 0.5 percent in the mid-1960s, and to current levels of about 0.27 percent.

(7) Developing countries have as a group accumulated considerable amounts of external debt. Their ability to service their debt repayment obligations will hinge on their individual capacities to deploy resources effectively in productive investments, not only to meet domestic objectives but also to earn foreign exchange.

The ultimate conclusion one can draw from these underlying "environmental" factors is that there is a need to focus greater attention on the role of private enterprise in development policies. In practice rather than by design, foreign assistance strategies traditionally have tended to give short shrift to private sector activities, since foreign aid is viewed largely in terms of government-to-government transfers in the form of projects and programs.

One need only examine the nature of development to understand the central importance of private enterprise. Economic development is the process by which countries are transformed from having low incomes and low productivity into nations with high living standards and high productivity. In most cases, the incomes of the poor can rise only when they are provided with productive employment opportunities. A basic goal of development is to achieve growth that is sustainable over time. The key words here, raising incomes based on sustainable, increasingly productive activities, are largely synonymous with the nature and objectives of private enterprise. Therefore, Mr. Chairman, in our view it is incumbent upon U.S. development policy to include a private sector dimension, not as a shift away from humanitarian interests but indeed as a complementary means to reach humanitarian goals.

Nonetheless, Mr. Chairman, it is clear that private sector initiatives in the developing world have all too often been subject to misperceptions, excessively high expectations, wasted resources, and poor execution. At the same time, a "window of opportunity" has opened in many developing countries in the form of greater willingness to adopt those policy changes needed to develop the private sector. The real challenge we face, Mr. Chairman, is to capitalize upon this open climate and begin demonstrating some substantial progress in private sector growth and its collateral development benefits before the tide of opinion in many developing countries swings away from market-oriented economic approaches.

In part, Mr. Chairman, such an adverse policy reorientation can be avoided by a tempering of expectations regarding the degree and extent of the private sector's response to this more favorable investment climate. Private capital flows, particularly "foreign" capital, will not reverse course overnight and stream into previously hostile economic environments. Investors must, over time, become confident that a favorable shift in investment policies is not transitory. Similarly, host governments must strengthen the attitudes, institutions and infrastructure needed to maintain effective relationships with investors.

The U.S. government, for its part, Mr. Chairman, must demonstrate a willingness to moderate its own expectations, as well as to develop a better set of capabilities to assess the range of policy options available to LDC governments, and offer appropriately informed advice and counsel on effective strategies for implementing private sector initiatives.

U.S. policies aimed at promoting private sector development should be understood in the context of current and prospective trends in the international economic climate and as domestic conditions facing developing countries. These conditions should compel a realistic set of expectations for the likely near-term yeild of such efforts.

(1) The world economy is now experiencing an era of financial adjustment similar to but greater in intensity than that of the oil adjustment in the 1970s. Current financial trends have created the critical need

for policy adjustments in most developing countries seeking to regain financial integrity while at the same time pursuing acceptable growth patterns.

(2) The principal characteristic of the international economic climate for the foreseeable future will be considerable competition for shares of limited markets for both trade and investment.

(3) The previously predominant objective of rapid growth is being rethought due to the need for "adjustment" and for greater balance between growth and stability. However, the pursuit of adjustment versus growth has been applied in practice as an "either/or" choice, rather than as a set of objectives which can be sought in tandem.

(4) The successful adoption of appropriate economic policies in the near-term future will depend less on theoretical considerations and much more on operational strategies related to implementation. Developing-country officials may be clearly aware of policy changes required, but have not been provided with adequate blueprints on "how to get from here to there." Very often, ingrained political or economic constraints deter even the best efforts of policymakers to effect desired changes.

These conditions are likely to constitute the dominant forces underlying the economic climate for the next five to ten years. As such, they provide ample justification for developing countries to reorient economic policy strategies. In our opinion the U.S. must provide substantive and strategic support to developing-country efforts to modify policy mixes aimed at improving their business climates.

The economic environment facing most developing countries can be characterized as posing a series of both threats and opportunities. Potential threats from external sources include partial or full breakdowns of the international financial system, rising trade protectionism, and investment incentive "wars." The internal consequences of such threats include declines in per capita income, increases in unemployment, reductions in standards of living, and even widespread famine.

Ironically, a number of new opportunities have arisen as a direct derivative of the threats just described, and take the form of basic changes in attitudes. Many developing country leaderships have demonstrated more realistic attitudes toward alternative policy strategies, and have indicated a greater willingness to make and follow through on hard policy decisions. Given the fact that in many cases the limits of constraints (financial, budgetary, resource, etc.) have been reached, leaderships have undertaken serious efforts to rationalize economic conditions to improve productivity and efficiency. In other words, the atmosphere within which economic policy decisions are reached has been cleared to a certain degree by the realities of economic forces at work.

Therefore, serious U.S. efforts to vitalize private sector contributions to development should be structured to assist developing-country efforts to improve domestic business climates through the adoption of appropriate policies. A successful private sector initiative in developing countries would benefit the United States and other donor countries in three ways. First, a strengthening of private sector capabilities in the areas of finance, investment, and trade would reduce the need for economic assistance transferred through public sector programs. Second, if demonstrable benefits can be attributed to concrete policy changes, developing country officials would become more willing to enter into concrete forms of policy dialogue with donor country agencies at the pragmatic rather than rhetorical level. Finally, the evolution of policy approaches and structures toward private sector orientations would likely lead to increased compatibility between OECD and developing countries, thereby reducing economic policy conflicts and raising the potential for mutually beneficial commercial relations.

In short, Mr. Chairman, our work for both corporate and government clients, intent on maximizing mutually advantageous opportunities for private sector development in less developed regions of the world, prompts us to forecast substantial economic and, ultimately, political benefits from successful implementation of private enterprise strategies. Whether or not such opportunities will be realized will depend in large measure on how well we understand and how quickly we respond to the needs and characteristics of primary actors in both the public and private sector. We welcome this Committee's interest in these issues which we believe will critically affect the next generation of U.S.-developing country relations.

The CHAIRMAN. This committee stands adjourned.

[Whereupon, at 1.25 p.m., the committee adjourned, subject to call of the Chair.]

○